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The Conference Board

Volume 1, Number 1 May 1990

Economic Times

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The Missing Business Cycle

Edgar R. Fiedler

Recent signs and portents on the economy have been oscillating like a yo-yo. Some of this is just normal statistical noise, but lately the gyrations have been more pronounced than usual. The purchasing managers' index is up, housing is down. The trade balance strengthens, industrial production sags. On it goes. Every new statistic contradicts the one before. Overall, however, the economy just doesn't know where it wants to go.

The two most worrisome reports are the climb of long-term interest rates, which were already oppressively high, and the drop in consumer expectations, now partially recouped in March *(chart, p. 10)*. The escalation of interest rates has to be taken seriously, but our inclination is to dismiss the retrenchment of consumer spirits as no more than a momentary reflection of the explosion of fuel-oil, fruit and vegetable prices caused by the deep December freeze. We regard it, in other words, as an event that will not put a lasting chill (pun intended, alas) on the free-spending habits of Americans. Thus far, happily, the 1990 retail sales data confirm that judgment.

Offsetting the adversities are several favorable developments. Business is still raising investment spending. The dollar is still low enough to give American producers a 5-10 percent advantage over foreign competitors, which should lead to further gains in our international accounts. Inventories continue to be well behaved, as Adrian Dillon points out elsewhere in this issue.

Whether the negatives outweigh the positives or vice versa,who knows? The guess here is that it's a Mexican standoff. The economy is directionless.

That's not how the profession and the media are playing it, however. The rhetoric of the economic pundits says we are still fighting the same old cyclical battles. The optimists, whose forecasts for 1990 average near 2 percent growth and 4 percent inflation, speak warmly about soft landings and a sustained expansion at high levels of resource utilization. The pessimists, whose forecasts for 1990 average near 2 percent growth and 4 percent inflation, speak darkly of sluggish demand and stagnation. One even compared the economy to water torture.

> *One day in 1988, while I was in the men's room, the business cycle slipped out a side door and hasn't been heard from since.*

What's out of place in this conventional discussion of the outlook is the continued emphasis on standard business cycle analysis. Such an approach is out of date. One day in 1988, while I was in the men's room, the business cycle slipped out a side door and hasn't been heard from since.

It'll be back! Sooner or later, when we're least expecting it, the cycle will reappear. But at the moment the business cycle is missing. Economic activity continues to expand gradually, with no inclination either to sag into recession or surge into boom. Similarly, the price indexes continue to rise at the accustomed rate, giving no sign of either quickening or moderating.

Consequently, there's little reason to be either an optimist or a pessimist about the economy, because for now at least the cyclical risks have all but vanished. It is in fact a rather dull state of existence.

Editor's Note

Welcome to *Economic Times*, a new publication from The Conference Board. Its aim is to bring you useful information and insights about where the economy is headed and the major policy issues under debate. To that end the publication will include the best analysis and interpretation we can find both within and outside the Board.

This month, in addition to the homegrown output, we include a colloquium on Rostenkowski's new deficit-closing proposal, Steve Roach's views about today's gut-wrenching cocktail-party issue (Is the price of my house headed south?), Adrian Dillon on inventories, and a sour verdict about fiscal politics from Don Conlan. In the "Conference Board Stat File" you will find charts of the key statistical series that were the mainstays of the *Statistical Bulletin* and several other publications, which *Economic Times* replaces. One of these series is new to us, the recession-risk calculation from the National Bureau of Economic Research.

We cordially invite your suggestions on how to improve *Economic Times*.

Maxim of the month:

An economist's best friend is his dogma.

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Economic Times (ISSN 0899-6741) is published 10 times annually (the July/August and November/December issues are combined) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022. Printed in Alpha, N.J.. Applications to Mail at Second Class Postage Rates is pending at New York, N.Y. Editor: Ed Fiedler

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Colloquium

Background:

Ways and Means Committee chairman Rostenkowski has proposed a 5-year deal to cut the budget deficit. His package includes higher taxes, and cuts in both defense spending and social benefits. The Democratic leadership says no deal without a major tax increase. The President is sticking with his no-new-taxes pledge but says let's talk.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Director, Economic Studies Program, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'-Andrea Tyson, Visiting Professor, Harvard University; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

Does budget gridlock still prevail or is there now a chance they will actually cut a deal?

Isabel V. Sawhill
The Urban Institute

Rostenkowski's political courage is refreshing and his plan is exactly the kind of everything-on-the-table compromise we badly need. But I doubt that there will be a deal. Neither the Democratic leadership nor the White House has endorsed the specifics of the plan. The approving noises emanating from the Administration are better understood as a tactical means of dividing the Democrats than as the precursor of a grand compromise.

Robert G. Dederick
Northern Trust Company

It certainly is possible that this will be the year for the Grand Budget Compromise. It also is possible that the Cubs will meet the White Sox in the World Series. As I understand it, the President isn't opposed to the Rostenkowski initiative; he's just opposed to what's in it. And even that puts him a step ahead of the Congresssional Democratic leadership. Somehow such muted enthusiasm does not appear to be the recipe for rapid progess. But, who wants progress in an election year anyway?

Murray Weidenbaum
Center for the Study of American Business

Dan Rostenkowski merits a silver star for gallantry for coming up with a specific plan to reduce the deficit. Unfortunately, his approach to curbing the flow of red ink will wind up being just foolhardy.

The Administration seems to be humoring him in the hope that the tax-increase tarbaby becomes securely attached to the Democrats. Because they are also playing the reluctant dragon on cutting spending, I doubt that any deal will be made.

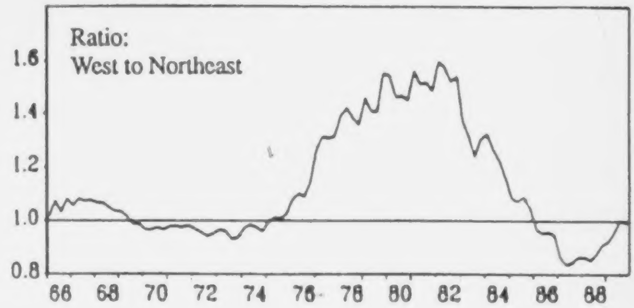
Charls E. Walker
Charls E. Walker Associates

The budget gridlock is not likely to be resolved until one or both of two things happens: a strong, popular President grasps the fiscal nettle and leads the battle for a major tax increase plus spending restraint, or voters finally perceive deficits as a threat to living standards and force their representatives to act. The Rostenkowski plan does not seem likely to lead to either requirement.

Surviving the Housing Crunch

By Stephen S. Roach

Relative Housing Prices



Concerns abound over the current softness in the housing market. Is there a real danger of a tumble in America's favorite asset play? How vulnerable is the U.S. economy to such an outcome?

Analysis

To begin with, housing prices are not collapsing. For the nation as a whole, the median price for existing homes rose about 4% in 1989 — little different from the 5% average gains over the past decade. Of course, the market has been very soft in the Northeast for well over a year. But this downshift is hardly suprising following a five-year period when home prices in this region esentially doubled by surging ahead at an unsustainable 16% rate per annum. To better gauge the balance of the regional disparities that have long been a way of life in the national housing market, we have examined recent changes in home prices for 83 localities — covering a broad cross section of the United States. It turns out that the widely publicized declines in the metropolitan areas of New York, Boston, Phoenix, and Detroit have been more than offset by impressive gains evident in the areas surrounding Chicago, Cleveland, upstate New York, and along the West Coast. And, for the remainder of the country, recent home price gains have been clustered in the 5% vicinity.

To be sure, in the 1980s, house price appreciation slowed dramatically from the double-digit pace of the late 1970s. But this should hardly be suprising in today's environment of relatively subdued inflation. The need was sharply diminished for housing to serve as a hedge against inflation's corrosive destruction of living standards — especially given the outstanding performance of financial assets in the 1980s and shifts in the tax code that raised after-tax mortgage costs in excess of 40% for most families.

But, even if the unthinkable does happen and home prices experience a protracted and widespread downslide, the U.S. economy will survive. Vulnerability on this score will very much be determined by the integrity of the household balance sheet. Fortunately, the ratio of household sector net worth in homes relative to wealth in financial assets has fallen steadily in the 1980s and currently stands at about 25% — fully 20 percentage points below the highs at the beginning of the decade and almost completely retracing the gains of the 1970s.

THIS SUNDAY
SPECIAL
PRAYERS
FOR THE
HOUSING
MARKET

Joseph Farris
c. Dec. 1989 *Barron's*

Moreover, it turns out that over the course of the current expansion, only about 11% of the cumulative rise in household wealth since 1982 can be attributed to rising net worth in housing — a far cry from the roughly 40% share that was evident in the two upturns of the 1970s. This outcome does not, of course, represent a conscious flight away from homeownership but, instead, simply reflects the sharp appreciation in the value of financial assets as juxtaposed against a more subdued appreciation of home prices. Thus, contrary to conventional wisdom, the 1980s have demonstrated that the economy's built-in mechanism for balance sheet protection is alive and well.

Strategic Implications

- As the Great Inflation was unwound, a slower rate of home price appreciation has emerged as one of the hallmarks of the current expansion — a trend that should endure in the 1990s.
- While geographic disparities occur frequently, the recent softening in Northeast home prices essentially brings this region back into rough alignment with the West — restoring equilibrium to the national housing market *(see chart).*
- Housing has made a minimal contribution to U.S. wealth generation in the 1980s — suggestive of a suprising resilence if real estate values sag unexpectedly.

Reprinted from *Morgan Stanley, Economic Perspectives, January 1990.*

Crosscurrents in Nationwide Home Prices
(Changes by Metropolitan Area From Third Quarter 1988 to Third Quarter 1989)

Down

Phoenix (-6.7%)
Worcester, MA (-6.7%)
New York City Area NY/NJ/CT(-4.7%)
Oklahoma City (-4.1%)
Saint Louis (-3.5%)
New Haven/Meriden (-2.9)
New Orleans (-2.5%)
Little Rock/N. Little Rock (-2.0%)
Tulsa (-1.7%)
Kansas City (-1.1%)
Fort Lauderdale/Hollywood/ Pompano Beach (-0.9%)
Baton Rouge (-0.3%)
Boston (-0.3%)
Detroit (-0.3%)
Hartford (-0.2%)

Up 0 to 5%

San Antonio (+0.0%)
Providence (+0.1%)
Albuquerque (+0.1%)
Salt Lake City/Ogden (+0.4%)
Chattanooga (+1.1%)
Philadelphia (+1.8%)
Jacksonville (+1.8%)
Minneapolis/St. Paul (+2.1%)
Pittsburgh (+2.1%)
Memphis (+2.2%)
Orlando (+2.3%)
Wichita (+2.9%)
Springfield, MA (+3.1%)
Rochester, NY (+3.2%)
Lexington/Fayette (+3.4%)
Spokane (+3.5%)
Charleston, SC (+3.6%)
Birmingham, AL (+3.9%)
Toledo (+4.0%)
Daytona Beach (+4.1%)
Madison, WI (+4.2%)
Greenville/Spartanburg (+4.2%)
Miami/Hialeah (+4.8%)

Up 5 to 10%

Mobile (+5.0%)
El Paso (+5.5%)
Corpus Christi (+5.5%)
Alanta (+5.5%)
W. Palm Beach/Boca Raton (+5.5%)
Raleigh/Durham (+5.7%)
Omaha (+5.8%)
Milwaukee (+5.8%)
Louisville (+5.9%)
Knoxville (+5.9%)
Columbia, SC (+5.9%)
Nashville/Davidson (+6.3%)
Peoria (+6.3%)
Syracuse (+6.4%)
Akron (+6.4%)
Dallas (+6.9%)
Washington, DC (+7.0%)
Baltimore (+7.2%)
Montgomery, AL (+7.2%)
Des Moines (+7.6%)
Indianapolis (+7.9%)
Lansing/E. Lansing (+7.9%)
Las Vegas (+8.2%)
Houston (+8.2%)
Cincinnati (+8.4%)
Tampa/St.Petersburg/ Clearwater (+8.7%)
Denver (+9.1%)
Columbus, Ohio (+9.1%)
Fort Worth/Arlington (+9.5%)

Up 10% or More

Chicago (+10.5%)
Portland, OR (+10.8%)
Grand Rapids (+11.2%)
Buffalo/Niagra Falls (+11.4%)
Cleveland (+11.6%)
Dayton/Springfield (+13.2%)
Charlotte/Gastonia/ Rock Hill (+14.5%)
Orange County (Anaheim/ Santa Ana) (+14.6%)
Sacramento (+16.3%)
San Diego (+17.3%)
Riverside/San Bernadino (+17.4%)
Albany/Schenectady/Troy (+17.7%)
Los Angeles Area (+18.7%)
Honolulu (+21.7%)
Seattle/Tacoma (+22.5%)
San Francisco Bay Area (+23.1%)

Source: National Association of Realtors and California Association of Realtors

Interview

Dillon on Optimism and Inventories

Adrian Dillon
Assisitant Treasurer
and Chief Economist,
Eaton Corporation,
Cleveland

TCB Reporter: You have a reputation for chronic optimism about the economic outlook, isn't that so?

Dillon: *Yes, but to be more precise it's not my optimism that's chronic, it's the rather steady expansion of the economy for 7 straight years now.*

TCB: So you claim it's the other forecasters who keep calling for a recession that doesn't show up who, by contrast, give you a reputation as an inveterate optimist. Is that it?

Dillon: *You're putting words in my mouth, and making enemies for me, but I guess that's more or less right.*

TCB: And you're still optimistic for 1990? Why?

Dillon: *Yes. There are several reasons but the most important is what the Federal Reserve has done. From January 1988 to April 1989 the Fed preemptively tightened monetary policy to cool off an overheated economy. They succeeded in preventing a new inflationary spiral from developing. Since then, just as deliberately, the Fed has been lowering short-term interest rates to prevent a cooling economy from heading into the deep freeze of recession, and this too appears to be succeeding. Another reason is illustrated by the accompanying chart.*

TCB: Interpret the chart for us, please.

Dillon: *The chart is designed to give advance warning of inventory overbuilding. The first point is that inventories of nondurable goods are not a problem. They're virtually never a problem, in fact, because food, chemicals, paper and other nondurables get sold quickly after they're produced. Nobody holds much inventory of nondurables—only about one-month's supply on average.*

TCB: So the trouble comes in durable goods?

Dillon: *Yes, if there is a problem, you find it in the durable-goods sector.*

TCB: Why do you exclude automobiles from your chart?

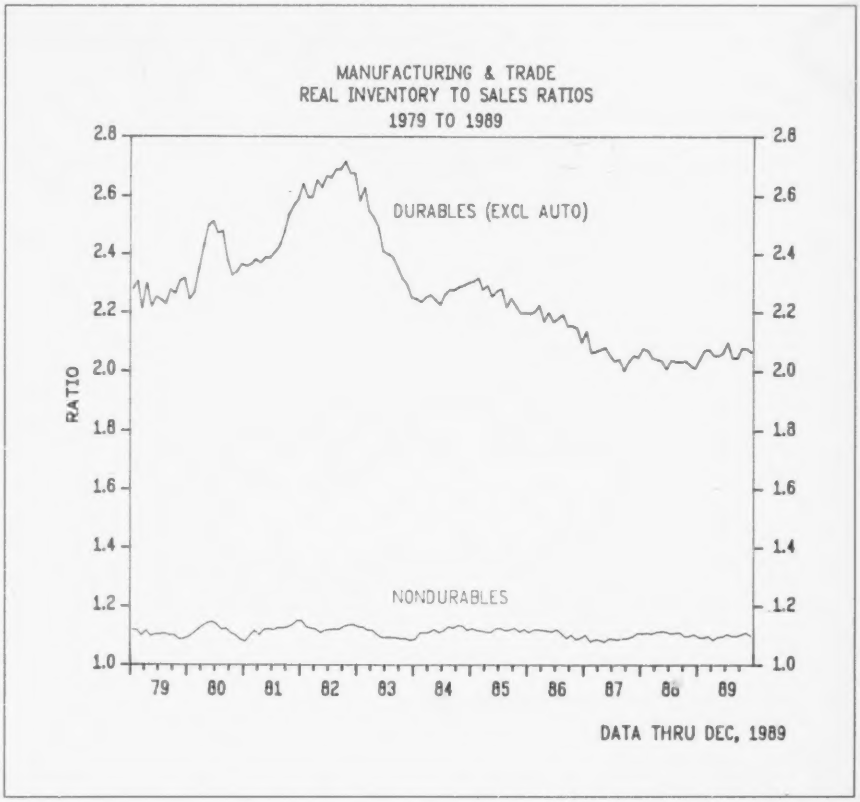
Dillon: *The auto industry marches to a different drummer than other durable-goods industries, so you have to look at it separately.*

TCB: Any problem now, either in autos or elsewhere?

Dillon: *No. Autos had a problem until January, but they fixed it by cutting prices and production, so stocks are pretty much back in line. And as the chart shows, the rest of the sector has done a remarkably good job of keeping inventories under control. There is no reason at all to think that business will have to slash orders and production in order to bring inventories back into balance.*

TCB: And thus no reason for you to stop being a cock-eyed chronic optimist?

Dillon: *Yea, I'm not going to lose my reputation this year.*



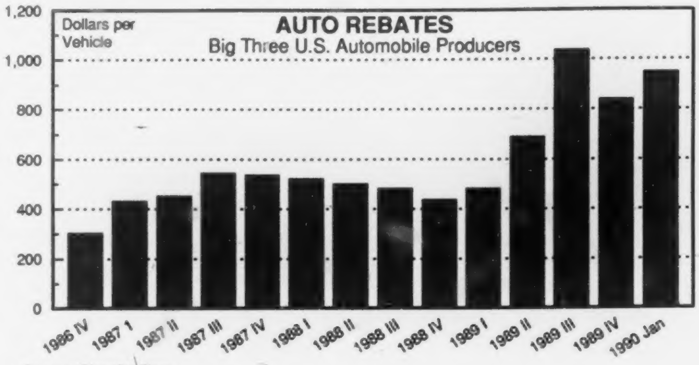
Auto Rebates and Turkish Bazaars

The jump in rebates on new cars over the past 6-9 months *(chart)* has often been interpreted as a signal of recession-like weakness in consumer demand. In our view this is much too pessimistic. What seems to be overlooked is that the rebates are simply a new way to set prices. We've always had list prices and dealer discounts and occasionally discounts from the manufacturers to the dealers. Now producer rebates paid directly to the buyer have become standard, adding still another more-or-less-permanent dimension to the structure of car prices. It's as confusing as a Turkish bazaar.

The purpose of the rebates is to stabilize demand and thereby keep costs down. The auto companies have learned from the Japanese how much more efficient it is to keep their assembly lines running at steady, high rates. So if sales lag behind production and current inventories get out of control, cutting prices can actually cost the company less than stopping and restarting an assembly line.

The boost in rebates could still be a response to weak consumer demand. But that's only one of many possibilities. An increase in rebates could also come about because the manufacturers' sales expectations and thus production rates were too high to start with. Alternatively, rebates might have to be lifted if auto-price increases (to cover mandated safety improvements or for any other reason) depressed auto demand. In that situation the problem is car prices, not weak consumer demand. In any event, it's a tricky matter and often misleading to judge the strength of general consumer demand from the size of the auto rebates.

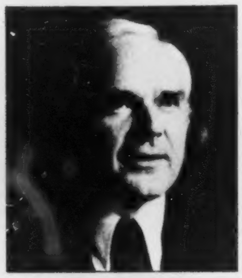
The best indicator, still, is sales volume. Total consumer spending continues to rise smartly. Within the industry, sales of autos and light trucks have been fairly steady for a couple of years now, down a little from the peak in 1986 but basically on trend. This suggests the auto market is in reasonably good shape but in the mature phase of the cycle. Thus, although we reject the idea that recent consumer demand for motor vehicles is "recession-like," neither has it been robust. What we are looking at, evidently, is a mature market that is doing OK but offers little growth potential for the economy.



Source: Chrysler Corp.

Quotable Quote

February 1990



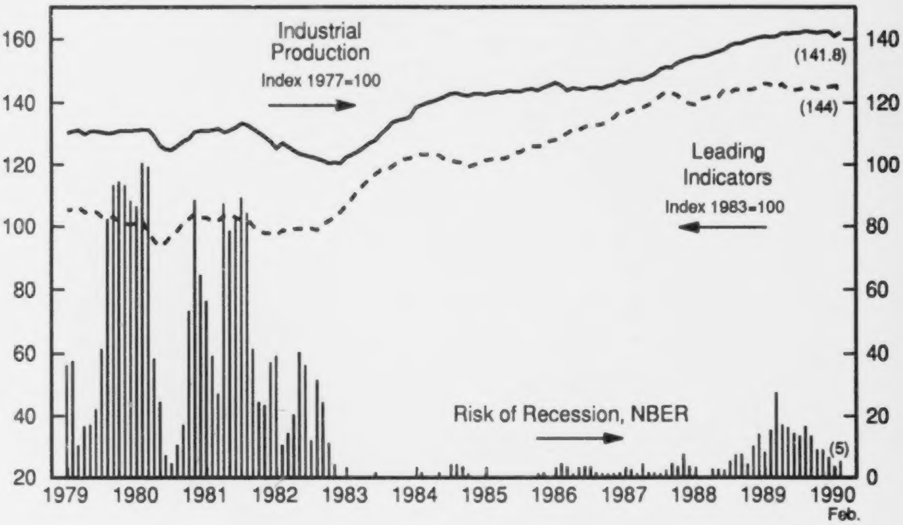
Don R. Conlan
Capital Strategy
Research, Inc.

Thus far I have said nothing about U.S. fiscal policy for the reason that there is no fiscal policy, except by accident. It has become a political free-for-all with no one even embarrassed by the chicanery and everyone, including the Administration, playing games. Unless there is a significant social security tax reduction (Can you believe that it's being discussed?) the economic impact of fiscal policy will probably be neutral to moderately restrictive for most of this year, again by accident, of course. On the other hand, a large tax cut, while it would stimulate the real side of the economy, probably would devastate the financial side, coming, as it would, with no credible spending reductions. It would also disillusion foreign holders of U.S. dollar assets, to the detriment of the dollar. If we are as close to full labor force utilization as I think we are, additional artificial demand stimulation combined with a weaker dollar are not the stuff of price stability, and that should be thoroughly disconcerting to the Federal Reserve.

Conference Board Stat File

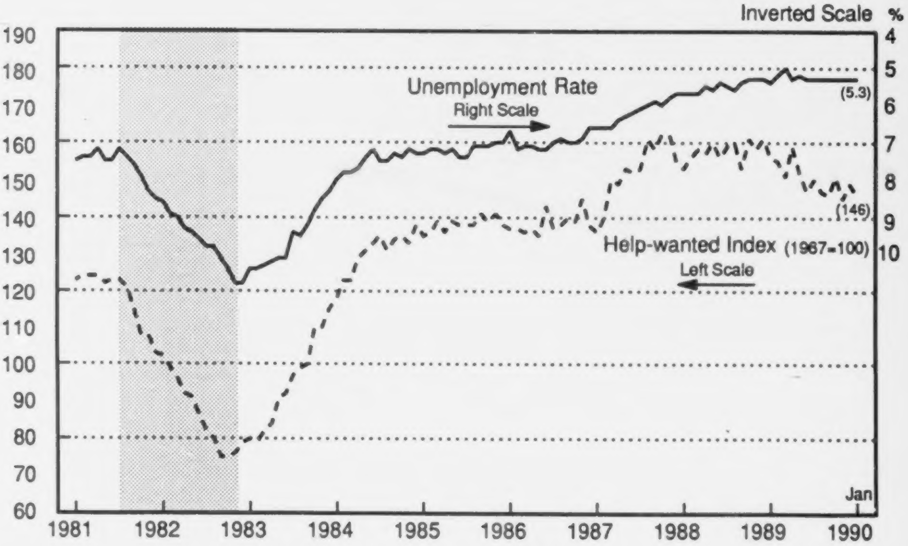
As the charts and forecasts on the next few pages reveal, the business cycle is still in forward gear, but at limited speed. Most encouraging, the calculation *(chart below)* by Mark W. Watson of Northwestern University and the National Bureau of Economic Research shows the risk of recession to be a minimal one in 20. Yet at the same time the leading indicators have been flat for a year. The Conference Board's help-wanted ad volume and the indexes of economic momentum *(next page)* are equally uninspiring. In sum, recent economic reports run the full range from tedium to apathy. *(Note: Data for Conference Board series in this section are available on request; please call Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Economy drifting comfortably. Recession chances remote.

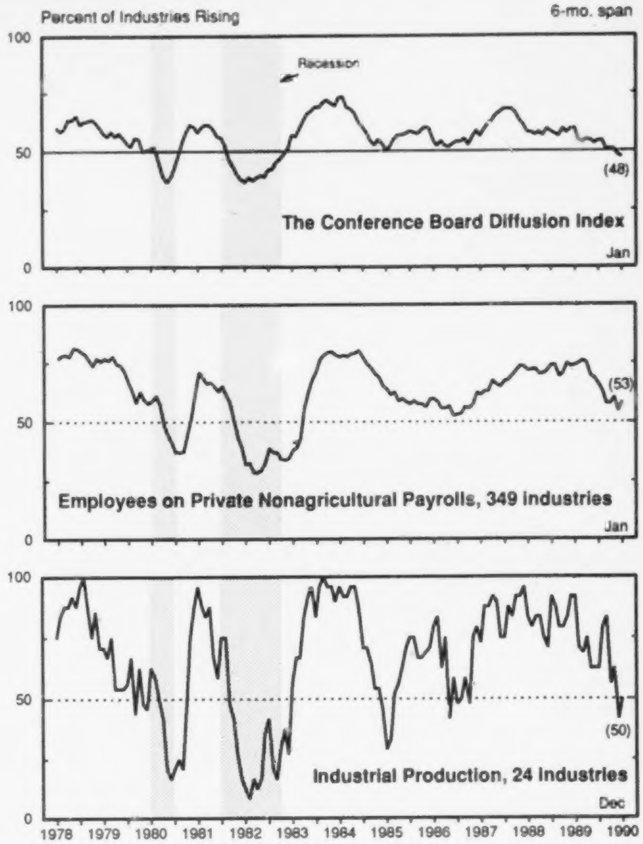
Help-wanted Advertising and Unemployment



Labor demand a bit softer.

Conference Board Stat File

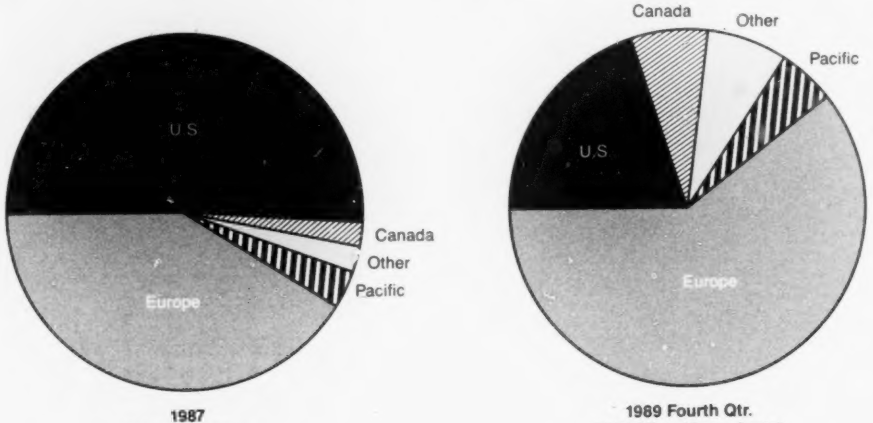
Indexes of Economic Momentum



Earlier momentum stalled, but not reversed.

Japanese Overseas Investors Turn from United States to Europe

Overseas Net Purchases of Stocks and Bonds by Japanese Long-Term Institutional Investors



1987
Total $69 billion

1989 Fourth Qtr.
$93 billion (Annual rate)

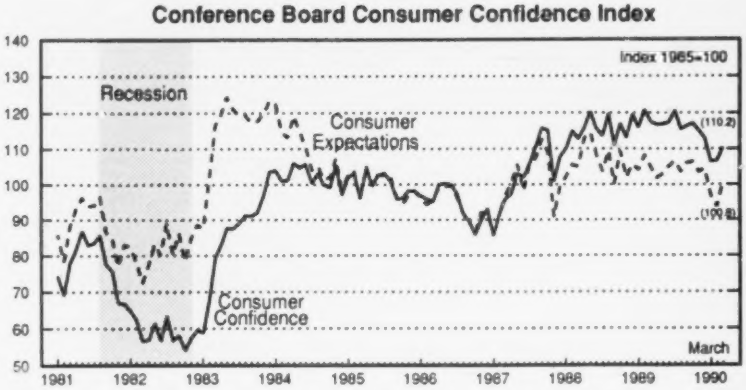
Source: Japanese Securities Dealer Association.

Comment: The general stability of U.S. long-term interest rates over this 3-year span is a telling rebuke to those who foresaw financial-market disaster if and when the Japanese moved away from U.S. investments.

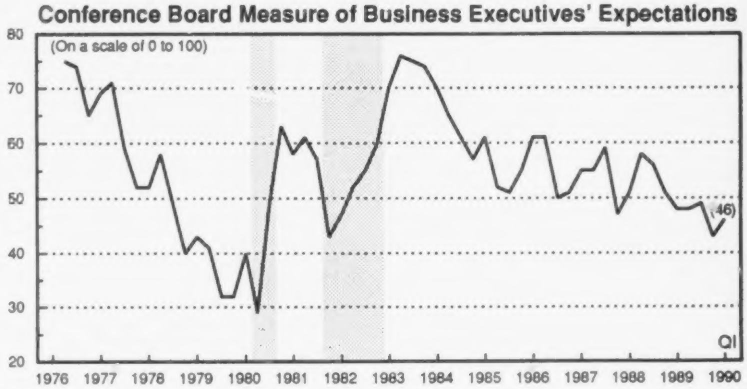
Conference Board Stat File

Confidence

Consumers a little more uncertain.

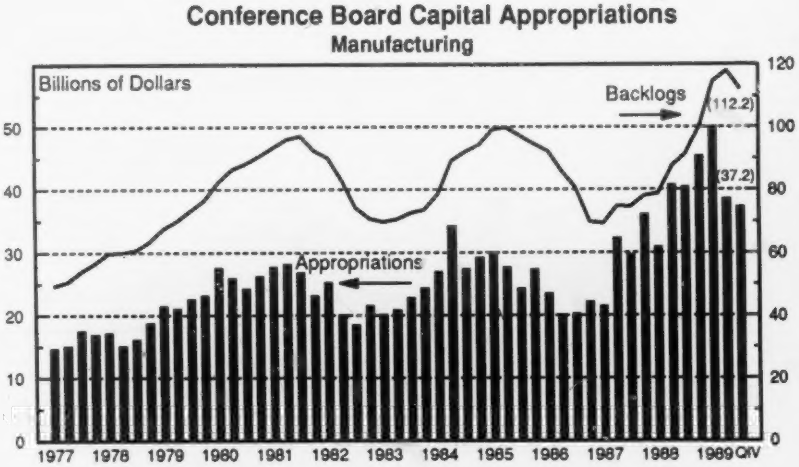


Executive attitudes mixed but drooping.



Investment Intentions

Expansion plans have eased a bit.



Inside the Crystal Ball

Economic Forecasts

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		Feb.	Feb.	Feb.	Feb.	[illegible]	Feb.	Feb.	Feb.		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%		%	%	%		
Actual	1989 3Q	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3Q 1989	Actual
	4Q	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	4Q	
Forecast	1990 1Q	1.2	2.4	1.1	2.0	2.2	1.5	1.9	1.7	1Q 1990	Forecast
	2Q	1.7	2.7	1.2	1.9	3.7	2.2	2.6	2.1	2Q	
	3Q	2.1	2.3	2.0	2.4	3.6	2.0	2.3	2.4	3Q	
	4Q	1.8	1.5	2.4	2.8	2.8	1.8	1.9	2.5	4Q	
	1991 1Q	1.7	1.7	2.7	0.6	2.1	2.2	2.7	2.3	1Q 1991	
	2Q	1.8	2.3	3.0	1.4	2.3	3.3	2.6	2.6	2Q	
	3Q	2.0	2.2	3.2	2.1	2.8	2.2	2.3	2.4	3Q	
	4Q	2.2	2.3	3.5	2.3	3.4	2.4	2.0	2.6	4Q	
	1992 1Q	2.4						2.4	2.7	1Q 1992	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	1989 4Q	Actual
Forecast	1990 4Q	4.3	4.4	4.0	4.1	3.6	4.1	3.6	4.2	1990 4Q	Forecast
	1991 4Q	4.0	4.2	3.9	4.1	4.0	4.1	3.9	3.9	1991 4Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 3Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	3Q 1989	Actual
	4Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	4Q	
Forecast	1990 1Q	5.5	5.3	5.3	5.3	5.3	5.3	5.3	5.3	1Q 1990	Forecast
	2Q	5.6	5.4	5.5	5.3	5.3	5.4	5.4	5.3	2Q	
	3Q	5.7	5.4	5.6	5.2	5.3	5.5	5.4	5.3	3Q	
	4Q	5.9	5.5	5.6	5.4	5.3	5.6	5.4	5.2	4Q	
	1991 1Q	5.9	5.5	5.6	5.5	5.3	5.7	5.4	5.2	1Q 1991	
	2Q	5.9	5.4	5.5	5.6	5.3	5.6	5.4	5.2	2Q	
	3Q	5.9	5.4	5.4	5.5	5.3	5.5	5.3	5.1	3Q	
	4Q	5.9	5.4	5.3	5.5	5.3	5.5	5.3	5.1	4Q	
	1992 1Q	5.9						5.3	5.1	1Q 1992	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

R4105-80

The Conference Board

Volume 1, Number 2 June 1990

Economic Times

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- **The Crystal Ball** *(page 11)*

Editor's Note

Since our first issue was published, we've been to the theatre —"Off Broadway," as they say. From that show, "Other People's Money," we are bringing you *(pages 4 and 5)* a portion of the play's climax, consisting of two speeches, one by the CEO of a doughty old New England company, and the other by Larry the Liquidator, the corporate raider who wants to break up the company and sell off the pieces for scrap. It's an insightful episode.

In addition, this issue features the views of our *Colloquium* on the President's "Family Savings Plan" and his proposal to cut capital gains taxes, Roz Wells' list of ten major trends affecting retailers, and the resurrection of an old analytical concept, the "core" inflation rate, by Gail Fosler and myself. Also, we offer our regular *Conference Board Stat File*.

We're always glad to hear from readers, thorns as well as roses, but most important with suggestions on how we can make *Economic Times* more useful to you.

Maxim of the month:

Economics is the only profession in which a person can rise to eminence without ever being right.

Attributed to the late George Meany

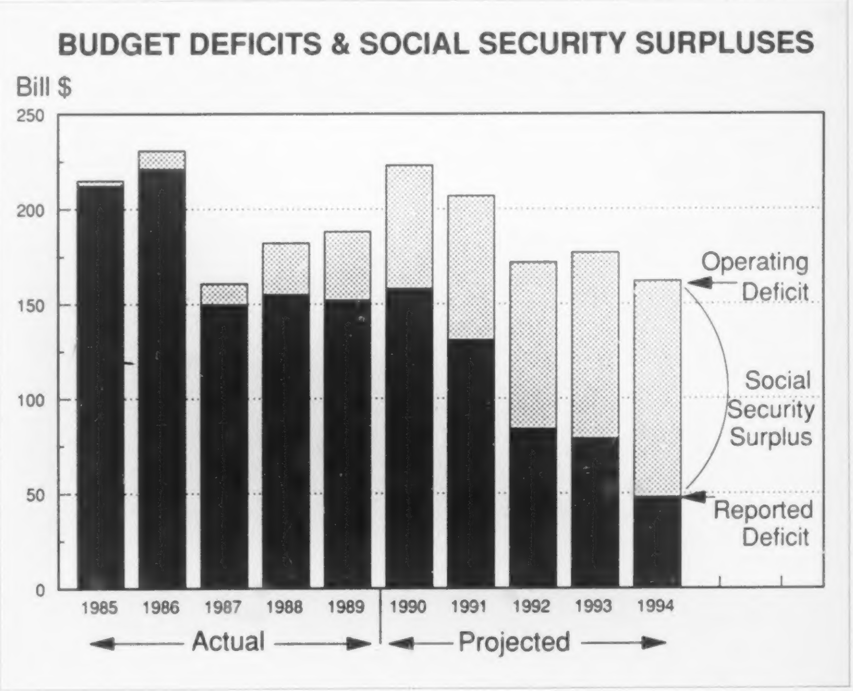
Moynihan's Complaint

Surpluses in the social security trust funds, Senator Moynihan complains, are not being saved to pay for the benefits today's workers will receive when they retire, but are, instead, being used to finance other current federal spending — and in the process masking the true size of the government's operating deficit. This is a correct statement, as the chart shows.

Moynihan's solution? Cut social security taxes by $55 billion in 1991 to put the system on close to pay-as-you-go financing from then on.

The rejoinder to the Senator is that, although it's true the social security surplus was never intended to pay for current federal outlays, by itself a cut in social security taxes would make the situation worse rather than better. Why? Because it would mean a still larger budget deficit, which would require still more borrowing by the Treasury from the private sector. The result would be to leave a still smaller pool of savings available to finance productivity-enhancing new investment. And if we don't supply future workers with enough modern capital equipment, they will not be able to produce the larger output necessary to meet the retirement needs of today's workers after they quit working early in the next century. Thus cutting social security taxes would hurt, not help. The problem and its solution are not with social security alone; they are to be found in the total budget deficit and the effect it has to supress national savings and investment.

Ed Fiedler


BUDGET DEFICITS & SOCIAL SECURITY SURPLUSES

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Ed Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium

The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

Among the major industrial nations, the United States is normally ranked near the bottom in saving and capital investment. This point is often used to explain our slow growth in productivity and living standards, and also our problems of international competitiveness. To this end, President Bush is advocating two changes in our tax laws.

Question:

Over the long term, will the proposed "Family Savings Plan" and a lower capital gains tax rate increase saving and investment?

James Tobin
Yale University

There they go again! In reverse. Over the longer term Bush's proposals will lower national saving, losing in federal revenues more than the nonfederal savings they induce. To boost national saving, raise taxes hitting consumption, channeling the revenues to deficit reduction and public investment. Start with gasoline, alcohol, and tobacco. Lay off virtuous-sounding proposals, Democratic or Republican, that reward affluent taxpayers for what they already do. Those are windfalls, not incentives.

Andrew F. Brimmer
Brimmer & Company

Neither plan will increase saving and investment over the long run. A tax-advantaged "Family Savings Plan" might influence the form in which unspent income is held (e.g., savings deposits). A lower capital gains tax would probably persuade some holders of appreciated assets to realize profits on a one-time basis. However, these basically conservative investors are unlikely to provide the risky equity capital needed by innovative entrepreneurs, who are the mainsprings of economic growth.

John T. Dunlop
Harvard University

Slow growth in productivity is the critical performance concern for the American economy. The efficiency of the economy depends on four factors: research and development, plant and equipment, public infrastructure such as roads and bridges, and human resource development. The "Family Savings Plan" and lower capital gains taxes may or may not make a small contribution to savings, but much more comprehensive and balanced private and public programs are essential to productivity and international competitiveness.

Charles L. Schultze
Brookings Institution

Attractive as it might seem politically, you cannot raise the nation's saving by lowering tax rates. The bulk of the evidence suggests that IRA-like tax incentives and reductions in capital gains rates will raise the *private* saving rate very little. But while they would do little to raise private saving, the tax loss they cause would in the long run increase the government budget deficit, and in the end reduce rather than raise total national saving.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Director, Economic Studies Program, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Visiting Professor, Harvard University; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Larry the Liquidator vs. New England Wire and Cable

The controversy over corporate takeovers involves a variety of complex issues: Who could manage the firm more competently, current management or the raiders? How much borrowing is appropriate for this balance sheet? Is the company better off dead or alive? This last issue is sharply drawn in Jerry Sterner's acclaimed play, "Other People's Money," which tells the story of a Wall Street takeover artist's attempt to gain control of a sturdy old New England company. The struggle reaches a climax at the company's annual meeting of shareholders. Here are excerpts from the speeches delivered at that meeting by the two protagonists, the company's benevolent and competent Chairman, Andrew Jorgenson, and the leader of the takeover forces, Lawrence Garfinkle:

Andrew Jorgenson:

Thank you for coming and welcome to the 73rd Annual Meeting of New England Wire and Cable — the 38th of which I am addressing you as your Chief Executive .... I'd like to share with you some of my thoughts concerning the vote you are about to make in the company you own.

We've had some very good years. We've had some difficult ones as well. ... We might not have flourished — but we survived. And we're stronger for it. I'm proud of what we accomplished. So, we're at that point where this proud company ... is in imminent danger of self-destructing this day in the town of its birth.

And there is the instrument of our destruction. I want you to see him in all his glory. Larry the Liquidator — the entrepreneur in post-industrial America — playing God with other people's money.

At least the robber barons of old left something tangible in their wake. A coal mine. A railroad. Banks. This man leaves nothing. He creates nothing. He builds nothing. He runs nothing. In his wake lies nothing but a blizzard of paper to cover the pain.

If he said, "I could run this business better." Well, that's something worth talking about. He's not saying that. He's saying, "I am going to kill you because at this particular moment in time you're worth more dead than alive."

Well, maybe that's true. But it is also true that one day this industry will turn. One day when the dollar is weaker or the yen stronger or when we finally begin to rebuild the roads, the bridges, the infrastructure of our country demand will skyrocket. And when those things happen we will be here — stronger for our ordeal — stronger for having survived. And the price of our stock will make his offer pale by comparison.

God save us if you vote to take his paltry few dollars and run. God save this country if *(Pointing to* Garfinkle.*)* "that" is truly the wave of the future. We will then have become a nation that makes nothing but hamburgers, creates nothing but lawyers, and sells nothing but tax shelters.

> *This, too, is murder, on a mass scale, only on Wall Street they call it "maximizing shareholder values."*

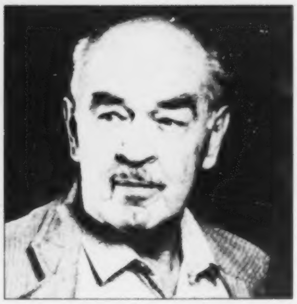
And if we have come to the point in this country where we kill something because at the moment it's worth more dead that alive, then turn around and take a good look at your neighbor. You won't kill him because it's called "murder" and it's illegal. This, too, is murder, on a mass scale, only on Wall Street they call it "maximizing shareholder values" and they call it legal and they substitute dollar bills where a conscience should be.

Damn it. A business is more than the price of its stock. It is the place where we make our living, meet our friends and dream our dreams. It is, in every sense, the very fabric that binds our society together.

So let us, right now, at this meeting, say to every Garfinkle in this land, that here we build things—we don't destroy them.

Here, we care for more than the price of our stock.

Here ... we care about people!



Arch Johnson as Andrew Jorgenson

Kevin Conway as Lawrence Garfinkle

Lawrence Garfinkle:

Say "Amen," someone, please!.... 'Cause that's what you just heard — a ... prayer for the dead ...

What — You don't think this company is dead? Steel — you remember steel, don't you? Steel used to be an industry. Now heavy metal is a rock group.

This company is dead. Don't blame me. I didn't kill it. It was dead when I got here. It is too late for prayers, for even if the prayers were answered and a miracle occurred and the yen did this and the dollar did that and the infrastructure did the other thing, we would still be dead. Know why? Fiber-optics. New technologies. Obsolescence.

We're dead, all right. We're just not broke. And you know the surest way to go broke? Keep getting an increasing share of a shrinking market. Down the tubes. Slow but sure ....

You invested in a business. And that business is dead. Let's have the intelligence, let's have the decency, to sign the death certificate, collect the insurance and invest the money in something with a future.

Aha — But we can't, goes the prayer— we can't because we have a responsibility — a responsibility to our employees, our community ... What will happen to them? I got two words for that — "Who cares?" Care about them? They didn't care about you. They sucked you dry. You have no responsibility to them.

For the last ten years this company has bled your money. Did this Community care? Did they ever say, "I know things are tough. We'll lower your taxes, reduce water and sewer?" Check it out. We're paying twice what we paid ten years ago. And the mayor is making twice what he made ten years ago. And our devoted employees, after taking no increases for three years, are still making twice what they made ten years ago. And our stock is one-sixth what it was ten years ago.

> *The business is dead. Let's invest the insurance money in something with a future.*

Who cares? I'll tell you — me! I'm not your best friend — I'm your only friend. I care about you in the only way that matters in business. I don't make anything? I'm making you money. And, lest we forget, that's the only reason any of you became stuckholders in the first place. To make money. You don't care if they manufacture wire and cable, fry chicken, or grow tangerines. You want to make money. I'm making you money. I'm the only friend you got.

Take that money. Invest it somewhere else. Maybe — maybe you'll get lucky and it will be used productively — and if it is — you'll create more jobs and provide a service for the economy and — God forbid—even make a few bucks for yourself....

And it pleases me that I'm called "Larry the Liquidator." You know why, fellow stuckholders? Because at my funeral you'll leave with a smile on your face ... and a few bucks in your pocket. Now, that's a funeral worth having.

There you have it, the essential issue: If Jorgenson is correct when he says that one day demand for the company's products will skyrocket, then his lean, mean company is definitely worth preserving. Alternatively, if Garfinkle is correct that fiber optics and other new technologies have made the company's products obsolete, then selling the assets for scrap is the best solution — best for the economy as well as best for the stockholders. In real life, takeover issues are never drawn so starkly and simply, but in "Other People's Money," it's all bound up in that single, unadorned difference of opinion.

Oh, you want to know who won the proxy battle? Well, it was — *No, that wouldn't be fair. I'd better stop here. If you want to know how it comes out, see the play.*

Ten Trends for Retailing in the 1990s

By Rosalind Wells

Rosalind Wells
President, Wells & Associates,
and Chief Economist
National Retail Federation

I. Population and Household Growth Will Slow

Growth in consumer purchases will be slower than in past decades — about 6 percent per year for general merchandise. Thus intense competition among retailers will continue —an unending battle for market share.

II. Changing Age Structure: Fewer Young Adults

The shortage of educated young employees will get worse. In response, stores will recruit from among retirees, handicapped, etc., and substitute capital for labor to raise productivity. Automatic systems for inventory replenishment and payments will catch on. As banking has learned, customers prefer machines to inefficient or overburdened clerks. Spending on standard appliances, basic furniture, and infant's apparel will be restrained.

III. Changing Age Structure: More Middle Aged and Older Folks

"Baby-boomers"— now aged 35-54 years — will rise from 25 to 30 percent of the population by the year 2000. On average, they will have 50 percent more income than households headed by someone under 35. Thus retailers will move upscale, change their image, upgrade merchandise, and add luxury goods.

More old folks means more spending for women's apparel, floor coverings, home textiles, eating out, entertainment, and personalized services such as interior decorating.

IV. Growing Importance of the World Economy

As the world's leader in distributing consumer goods, U.S. efficiency, innovation and marketing savvy should serve us well in other markets. Eastern Europe now presents a special opportunity.

V. A Less Pronounced Business Cycle

A more stable environment will lead to better planning. With smaller swings in consumer demand, the risks associated with aggressive merchandising will be moderated.

VI. Consumer Savings Will Increase

Federal incentives such as more liberal IRAs and lower capital gains taxes are on the horizon. More savings will mean slower growth in spending especially for cars and other durables. Services will continue to grow the fastest.

VII. Shifting of Social Costs onto Business

Labor-intensive retailers will be most vulnerable to efforts to increase the minimum wage, mandate private health insurance, increase the availability of child care, provide for parental leave, and redress persistent wage inequalities between men and women.

VIII. Women in the Workforce Will Continue to Increase

This puts a still larger premium on "time," which favors stores that have a clear identity and offer efficient and convenient shopping. Good product value and basic customer service will also continue to count heavily.

IX. Increased Diversity of Lifestyles and Family Situations

Retailers cannot be all things to all people. They must use target marketing on our increasingly heterogeneous population. It's not just getting *people* into the store, it's getting the *right* people in. Falling computer costs help make such targeting possible.

X. The Merger, Acquisition and LBO Craze of the 1980s Has Permanently Affected the Retail Industry

The common denominator is cost control. In an environment that features only modest sales growth, no one can afford to be the high-cost merchandiser.

The Bottom Line

is that the retailing world is changing dramatically. Running a store the same way it's always been done is not going to produce superior results in the future. Success will require that management quickly and accurately identify, interpret and react to emerging trends.

U.S. Population Distribution by Age

Age Group	1980	1990	2000	1980-90	90-2000
		% of total		*pct. pts.*	
Under 15	22.5	21.6	20.2	-0.9	-1.4
15-24	18.8	14.4	13.7	-4.4	-0.7
25-34	16.5	17.6	13.8	1.1	**-3.8**
35-44	11.4	15.1	16.4	3.7	1.3
45-54	10.0	10.2	13.9	0.2	**3.7**
55-64	9.5	8.5	9.0	-1.0	0.5
65+	11.3	12.6	13.0	1.3	0.4
Total	100.0%	100.0%	100.0%	0.0	0.0
Median Age	30.0	33.0	36.4		

Trouble at the Core?

The consumer price index (CPI) behaved badly in the first quarter, rising at a worrisome annual rate of about 8 1/2 percent. Although some temporary acceleration was expected from the 4 percent inflation rate that has marked the past half decade, the first-quarter surge was a great surprise, and helped create gloom, doom, and serious losses in the bond market.

Few analysts expect inflation to continue at the first-quarter pace. But how fast should we expect the general price level to rise? Is the recent surge simply a one-shot phenomenon, a spike in an otherwise steady inflation picture? Or is it the start of something bigger, something we need to worry about more than before?

To gain some perspective on this issue, *Economic Times* is resurrecting an old analytical concept, somewhat neglected recently, called the "core" or "underlying" inflation rate. The idea is simple: The CPI is stripped of its most volatile components, food at home and energy. These two groups are selected because they are large components of the CPI that experience wide erratic price swings often enough to distort the overall index. Removing those two components does not eliminate all aberrant behavior in the index, but it does produce a smoother series that makes it easier to spot meaningful changes in the inflation rate. A telling example is found in 1986, when the collapse of energy prices suppressed the CPI inflation rate to about 1 1/2 percent, but the core inflation rate continued to roll along at just over 4 percent.

If our surveillance of inflation is limited to prices, however, we're missing half the story. Inflation is a two-sided coin, prices on one side, costs on the other. Our best measure of costs--not an ideal series, but the best available — is the Employment Cost Index (ECI), an index of employee compensation including benefits as well as wages and salaries. Like the CPI, however, the ECI includes several elements that frequently obscure the underlying rate of employment-cost inflation, either because they are erratic or because they don't respond promptly to changing economic conditions. Specifically, these are social security taxes, bonuses and commissions paid to sales workers, and the compensation of state and local government workers. To see what's happening to the "core" rate, therefore, we remove the components that include these items and watch the rest, i.e., the wages and salaries of private-sector workers other than sales personnel. This series would be better if it included workers' medical benefits paid by employers, which are a major source of cost pressures, and if it took account of productivity gains, which are an offset. For now at least this is the best indicator available to show whether or not cost pressures are mounting.

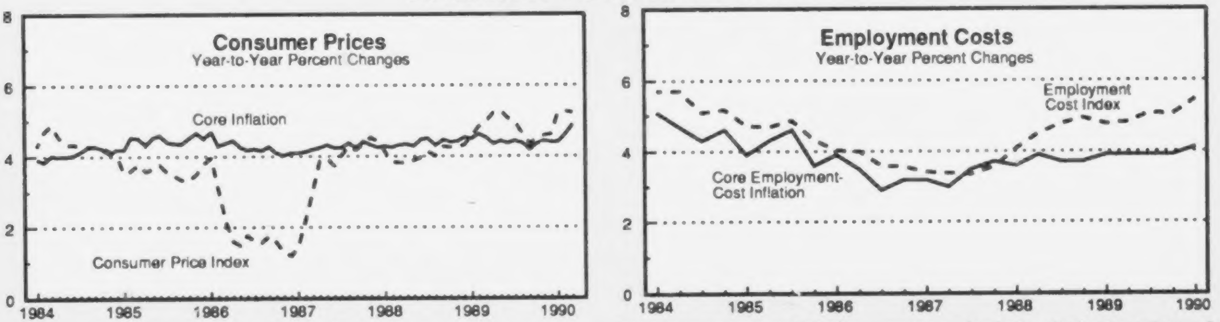
> *Inflation is a two-sided coin, prices on one side, costs on the other.*

What we find from the charts of these series (henceforth to be included regularly in the STAT FILE section of this publication) is that the threat of accelerating inflation is not as serious as the unadjusted CPI suggests. Both of our measures of core inflation, however, are emitting clear signals of continuing inflation and also, from the very latest figures, tentative signals of moderate acceleration — nothing like 8 1/2 percent but more than we've been experiencing. Moreover, the core rate of price inflation was held down in recent months by restraint in goods prices, which won't continue if the economy picks up steam.

For now, however, there's probably not enough trouble "at the core" to get worked up about. The best bet for this year is a 4 to 5 percent increase in the general price level. But the early 1990 data warn us that these indexes bear watching. A higher rate of inflation may lie just over the horizon.

Gail Fosler & Ed Fiedler

Inflation Fundamentals



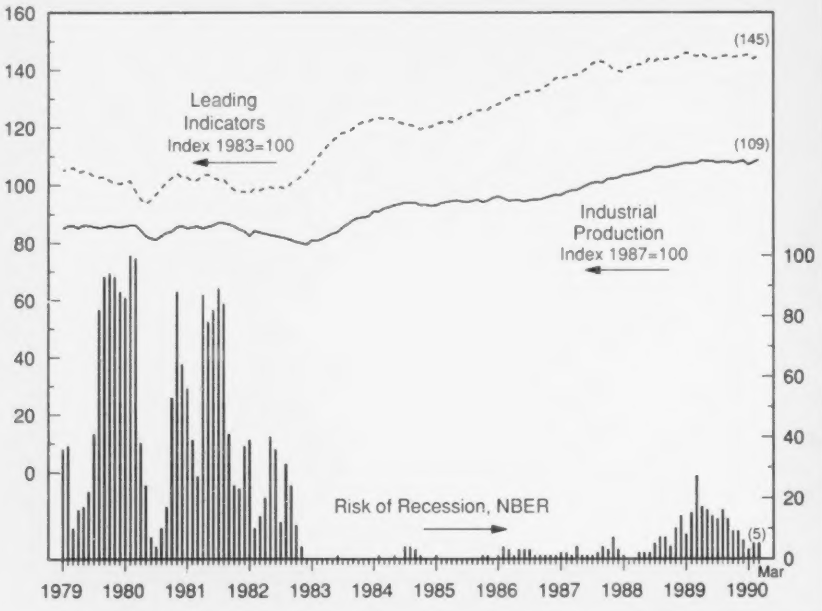
Core inflation = CPI excluding food at home and energy

Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

Conference Board Stat File

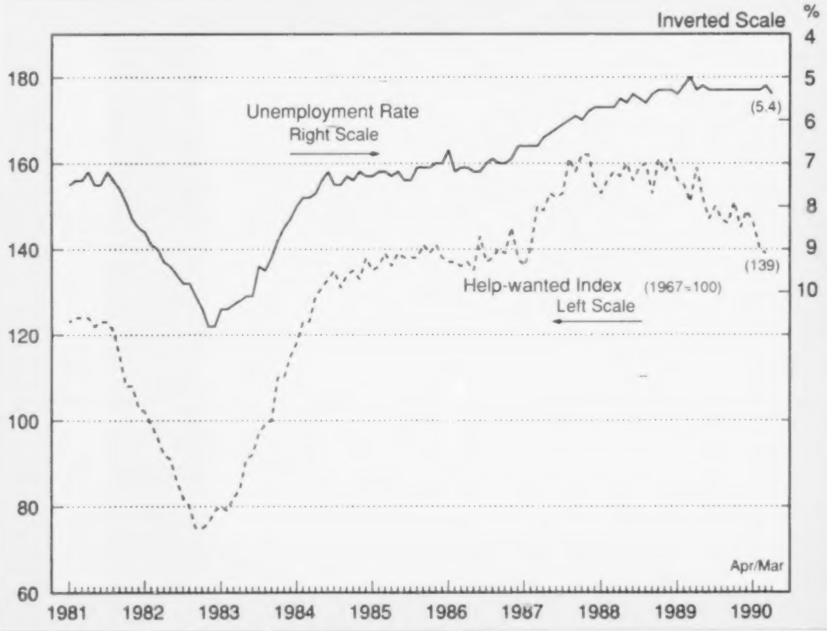
As the charts and forecasts on these pages show, the latest signs and portents tell the identical story as last month: The economy is still moving forward slowly, and staying out of trouble (or, if you prefer, avoiding worse trouble). The labor markets *(bottom of this page)* look just a touch weaker, while the momentum indexes *(next page)* have strengthened slightly. But that's how it's been going for about 18 months — every positive signal is countered by one moving the other direction In sum, the economy is still going nowhere fast. *(Note: Data for Conference Board series in this section are available on request; please call Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Economy drifting comfortably. Recession chances remote.

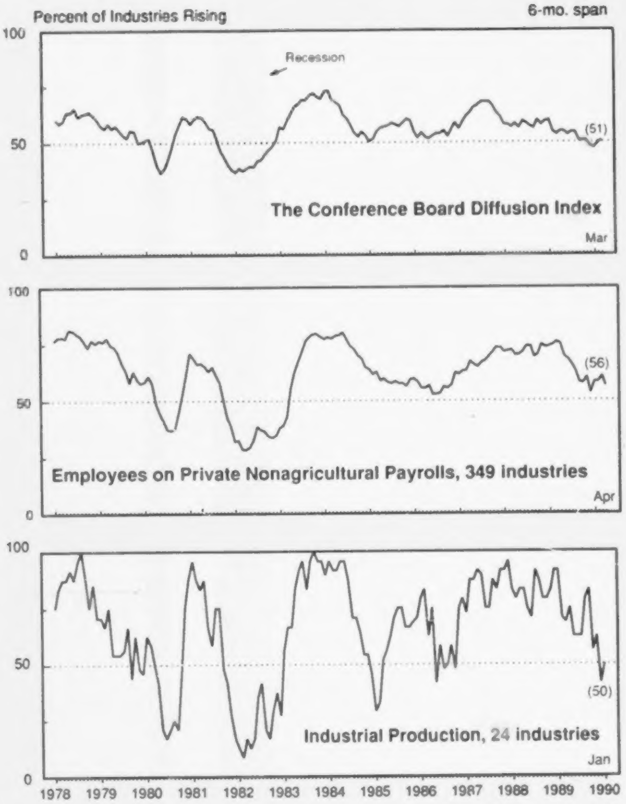
Help-wanted Advertising and Unemployment



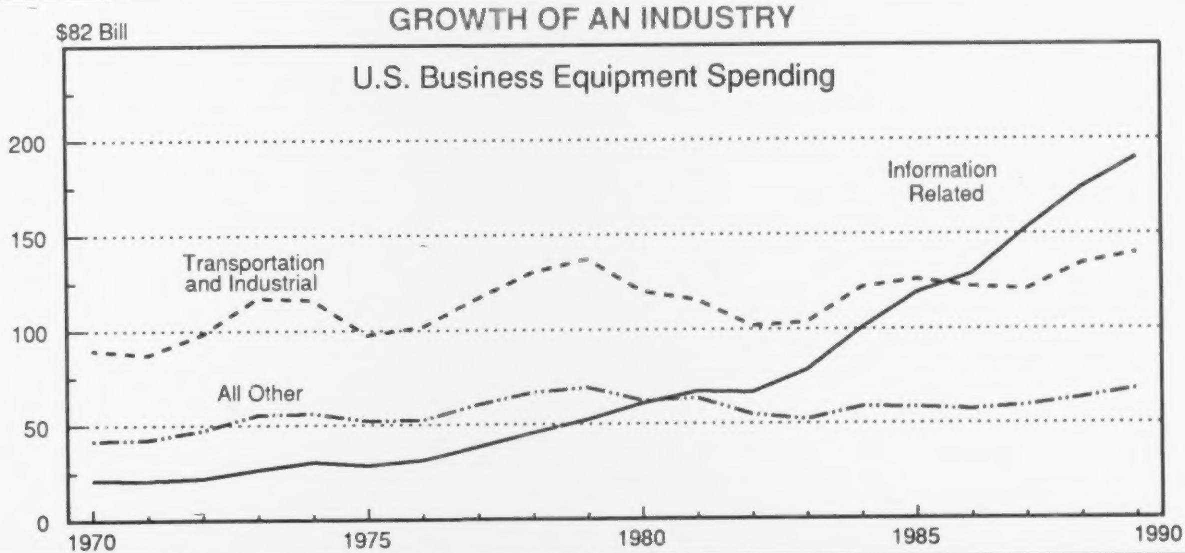
Labor demand softening.

Conference Board Stat File

Indexes of Economic Momentum



A Mexican stand-off.

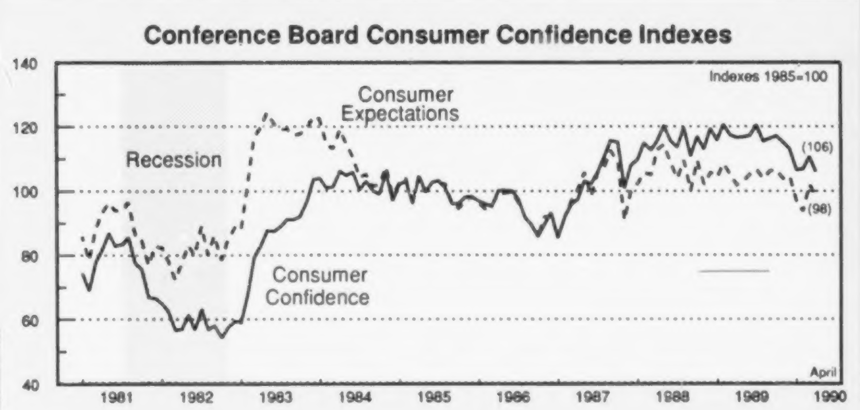


Comment: Mention "capital investment" to any economist with gray hair, and he'll immediately think of machine tools and semitrailers, because that type of equipment was the heavyweight of the investment sector for many decades. But no longer; the world turns, as this chart illustrates. Computers, communications gear and other information-related equipment have grown so dramatically for so long that they now completely dominate the category. Indeed, this year they will become more than half the total.

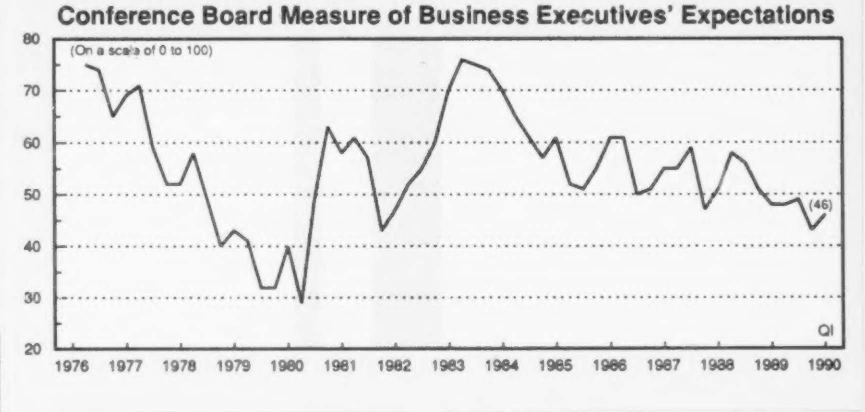
Conference Board Stat File

Confidence

Consumer attitudes: subdued but not sour.

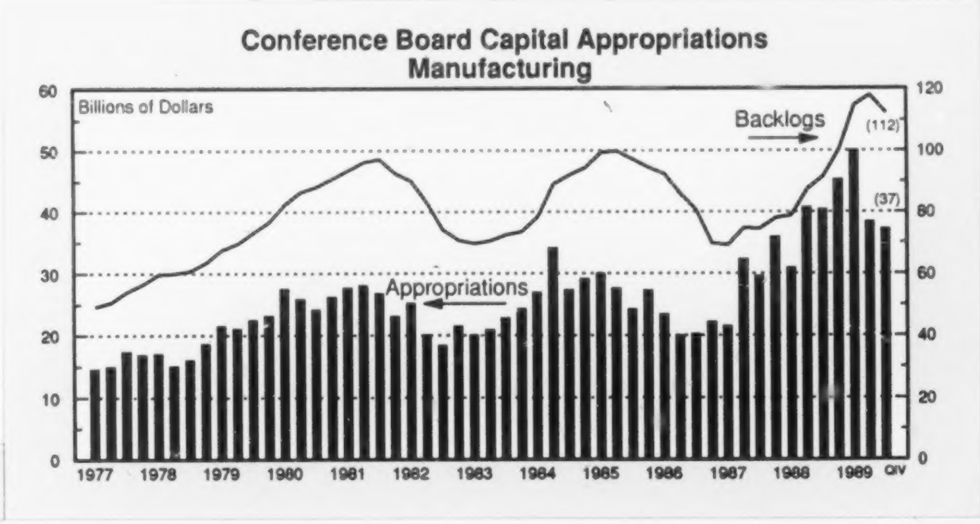


Executive attitudes: mixed but drooping.



Investment Intentions

Manufacturers' expansion plans off a bit.



Inside the Crystal Ball

	UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA
Date of Forecast	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%	%	%	%	%		
Actual	1989 4Q	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	4Q 1989	Actual
	1990 1Q	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	1Q 1990	
Forecast	2Q	3.2	2.8	1.6	2.2	3.6	2.4	3.0	3.0	2Q	Forecast
	3Q	2.0	2.3	1.6	2.2	3.5	1.1	2.3	1.5	3Q	
	4Q	1.7	1.5	1.5	1.3	2.8	1.1	1.3	1.9	4Q	
	1991 1Q	1.6	1.7	1.9	1.9	2.4	1.7	2.5	2.5	1Q 1991	
	2Q	1.8	2.3	2.5	1.4	2.3	2.9	2.2	2.3	2Q	
	3Q	2.0	2.4	3.0	2.3	2.2	2.2	2.1	2.3	3Q	
	4Q	2.2	2.5	2.8	3.0	2.8	2.6	1.5	2.5	4Q	
	1992 1Q	2.4		3.1		1.6	2.7	2.2	2.5	1Q 1992	
	2Q	2.6		3.4		1.8	2.4	2.7	2.5	2Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	1989 4Q	Actual
Forecast	1990 4Q	4.3	4.3	4.1	4.3	4.3	4.3	3.9	4.3	1990 4Q	Forecast
	1991 4Q	4.1	4.2	3.9	4.3	4.0	4.1	4.0	4.1	1991 4Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	4Q 1989	Actual
	1990 1Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	1Q 1990	
Forecast	2Q	5.5	5.3	5.3	5.3	5.3	5.2	5.3	5.3	2Q	Forecast
	3Q	5.5	5.4	5.4	5.2	5.3	5.3	5.3	5.4	3Q	
	4Q	5.6	5.5	5.5	5.4	5.3	5.5	5.3	5.5	4Q	
	1991 1Q	5.7	5.5	5.6	5.5	5.3	5.6	5.3	5.6	1Q 1991	
	2Q	5.7	5.4	5.5	5.6	5.3	5.6	5.3	5.6	2Q	
	3Q	5.7	5.4	5.4	5.5	5.3	5.6	5.4	5.6	3Q	
	4Q	5.7	5.4	5.3	5.4	5.3	5.6	5.4	5.5	4Q	
	1992 1Q	5.7		5.2		5.3	5.6	5.4	5.5	1Q 1992	
	2Q	5.7		5.2		5.3	5.6	5.4	5.4	2Q	

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The Conference Board

Volume 1, Number 3 July - August 1990

Economic Times

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- **Where Did All that Money Go?** *(page 4)*
- **Cry for Argentina!** *(page 5)*
- **Sommers Sorts Out the Foreign Investment Numbers** *(page 7)*
- **The Crystal Ball** *(page 11)*

Editor's Note

Last month we went to the theatre, this month it's South America. What we learned is found in the adjoining piece and on *page 5*. Another important focus this month is the S&L debacle, which is the subject for our Colloquium *(next page)* and for Ellis T. (Bud) Gravette, Jr., and myself *(page 4)*. (Bud is Chairman of Ardath Associates in La Jolla and former Chairman of the Bowery Savings Bank here in New York.) You'll enjoy, I'm sure, two quotable quotes with somewhat different points of view about the international competitive position of the United States *(page 6)*. We also offer the regular *Conference Board Stat File*, preceded by the first in a series of "Statistical Insight" columns by our distinguished colleague, Al Sommers.

In September, about half the copies of *Economic Times* will arrive wrapped in a separate cover that will contain a return card, designed so that you can let us know whether or not you want to continue on the distribution list, report any change of address, etc. There will also be room for comments, which we hope you will take advantage of.

Maxim of the month:

Forecasting the future is fraud with peril.

Apologies to the *Dallas Morning News*

No Pain, No Gain

Although the world's attention has been focused on the USSR and Eastern Europe lately, the shift to the economic right in Latin America has been equally dramatic. Everywhere you look, from Del Rio to Tierra del Fuego, revolution is underway. Yes, revolution! For Latin America, however, it is an entirely atypical revolution: nonviolent, democratic and libertarian.

The details of and the degree of commitment to these economic revolutions differ from country to country, but the main themes are common: In each country the design is to increase the standard of living and to stop inflation by:

- Shrinking the budget deficit
- Curtailing government payrolls
- Enforcing the tax code
- Eliminating subsidies
- Privatizing government-owned industries
- Deregulating private industry
- Ending price and wage controls
- Opening the economy internationally

The plans seem sensible, the politicians sound sincere, and the special-interest groups whose oxen are being gored are at least partially subdued. Furthermore, early policy initiatives, some of them extraordinarily bold — such as new President Collor "kidnapping" two-thirds of the money Brazilians ~~kept in banks~~ — have been encouraging. Mexico, perhaps, is farthest along. But these initiatives, important as they are, are only the beginning. Most of the really tough decisions have yet to be taken. It is, for example, relatively easy to announce that a government-owned railroad is to be privatized. it is a lot less easy to decide who are to become the new owners and under what terms. But what is really difficult is for the government to acquiesce when the new owners discharge 10,000 redundant employees!

It is not clear that the fragile structure of democracy in place throughout most of Latin America can withstand the pressures generated by the real-life consequences of innocent-sounding policy prescriptions such as "eliminate inefficient subsidies." As the Soviet people told Gorbachev recently: Oh yes, we want the economy modernized, but don't you dare raise the *(absurdly low)* price of bread in the process.

The inconsistency is obvious. Voters elect their political leaders to maximize pleasure and minimize pain. That's where all the subsidies, the bloated federal payrolls, and the inflation came from in the first place. But, when carried too far, a high and growing standard of living is also sacrificed , as the Argentine data on page 5 so vividly demonstrate. The problem boils down to this:

> **Economic progress requires change. Change means pain. No pain, no gain. But in democracy, pain is against the rules.**

This is the central issue of democracy: to reconcile that dilemma. Currently, the pendulum is swinging to the right everywhere south of the border. Whether the swing will carry through a full arc all the way to a high degree of economic efficiency with liberty is still to be tested. Prospects are better today than in a long time. But don't hold your breath, and don't bet the hacienda. How it will come out is not at all clear.

Ed Fiedler

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

The focus of S&L debacle has shifted recently to the inter-regional transfer of wealth that arises from the concentration of thrift bankruptcies in the Southwest. The contention is that other states are paying $500 to $1000 per resident to bail out the Southwestern states, and thus that the latter gain an economic windfall at the expense of the rest of the nation, where the strength of the economy is correspondingly sapped.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Director, Economic Studies Program, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Visiting Professor, Harvard University; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

Is this transfer of wealth something that should seriously concern the other states?

Albert M. Wojnilower
First Boston Corporation

To fund the bailout, the government sells securities worldwide. The proceeds go to reimburse S&L depositors and acquirers, many not from the Southwest and all essentially free to invest anywhere. The net regional effect is obscure and likely small.

When oil prices were controlled in the 1970s, the country benefited at the Southwest's expense. Only if now we had to pay higher taxes, as opposed to voluntarily buying securities, would the tables be turned.

Charls E. Walker
Charls E. Walker Associates

Concern might be justified if residents in the disaster states had caused the S&L debacle. But in fact the root cause was 55 years of lax legislation by the U.S. Congress and lax regulation by the agencies Congress created and oversaw. The S&L debacle is therefore a national problem. It should be treated on a national basis with all necessary funds coming from the nation's taxpayers.

Don Conlan
Capital Strategies Research, Inc.

A replay of King Solomon's dilemma with the same dire potential. This debate compounds a double felony; i.e., excessive deposit insurance in the first place and then the bailout. Red dye monitors on capital flows? Okay, how do Maryland and Virginia benefit from the presense of the Federal government, the Midwest from crop supports, etc. Forget it! Adam Smith lives! Capital flows to the best opportunities, regardless of location, and benefits accrue to the entire society. Don't let politicians put the invisible hand in the till!

Stephen H. Axilrod
Nikko Securities International

As a nation, we should be most concerned about learning from and not repeating the mistake that got us into the present mess. The bail-out's cost rose from merely extravagant to colossal because policy-makers refused to face the problems early and papered them over (literally so if you consider how capital deficiencies were often covered). Deposit insurance is desirable and kept the crisis from spreading, but the potential size of wealth transfer indicates the need for reform.

Where Did All the S&L Money Go?

By Ellis T. Gravette, Jr., and Edgar R. Fiedler

Most of the money went not to the fat-cats, but to honest, ordinary, everyday people

By now the thrift-industry debacle has been thoroughly documented and even, occasionally, well analyzed. There are still some misconceptions around — for example, that deregulation was a major cause of the problem, and that it is the industry *(rather than the depositors)* that is being bailed out. But these myths are gradually fading. And the main culprits have been accurately identified as the head-in-the-sand politicians in Congress, the Executive Branch and the Federal Home Loan Bank Board, plus a goodly number of corrupt or incompetent S&L operators.

The greatest remaining confusion is: What happened to all that money? Some popular accounts imply, as Massachusetts Senator Kerry did recently, that most of it was stolen by fraudulent operators, who have stashed it in untraceable offshore bank accounts. Yes, that did happen in more than a few cases totaling tens of millions, *maybe* even hundreds of millions of dollars. Big money by most standards, yes, but very small potatoes compared with the hundreds of *billions* — about $2,000 per U.S. household — lost by the S&Ls.

Well, where did the big money go? Although many people will be reluctant to accept this thought — because it's not a conspiracy theory — the answer is surprisingly simple. Most of the money was paid out in a multitude of honest, ordinary, everyday business transactions to two groups: First, to thrift depositors, especially those buying "jumbo certificates" from unprofitable thrifts offering above-market interest rates in a scramble to bring in enough new deposits to offset their losses — but also to depositors at profitable thrifts that were forced to compete with the fly-by-nights. All these depositors received excessive interest returns on their deposits, that is, higher interest rates than would have prevailed in a normal market. In total, massive amounts.

Second, the money went to everyone involved in the development of the high-risk real-estate projects financed by those imprudent loans made by the S&Ls — that is, to those who sold property to the developers, often at inflated prices, and then to all the contractors, bulldozer operators, plumbers, lumber warehouses, and other suppliers involved in the project. Again, in the aggregate, enormous sums.

The big money, in other words, went to ordinary Americans, indeed, to a fairly substantial fraction of the American people. It didn't go just to the wheeler-dealers and the fat-cats, but also to — well, do you remember your frugal Aunt Edith who always scanned the ads to find the highest insured interest rate for her nest egg? And your happy-go-lucky brother-in-law, the electrician, who was always taking off for Texas or wherever to work on some new construction project? They were among those who got the "big money," bit by bit. And that puts an ironic twist on the story, because it means that in the end the money went to many of the same people who, as taxpayers, are now going to have to pony up to set the whole mess right.

Argentina's Economic Tragedy

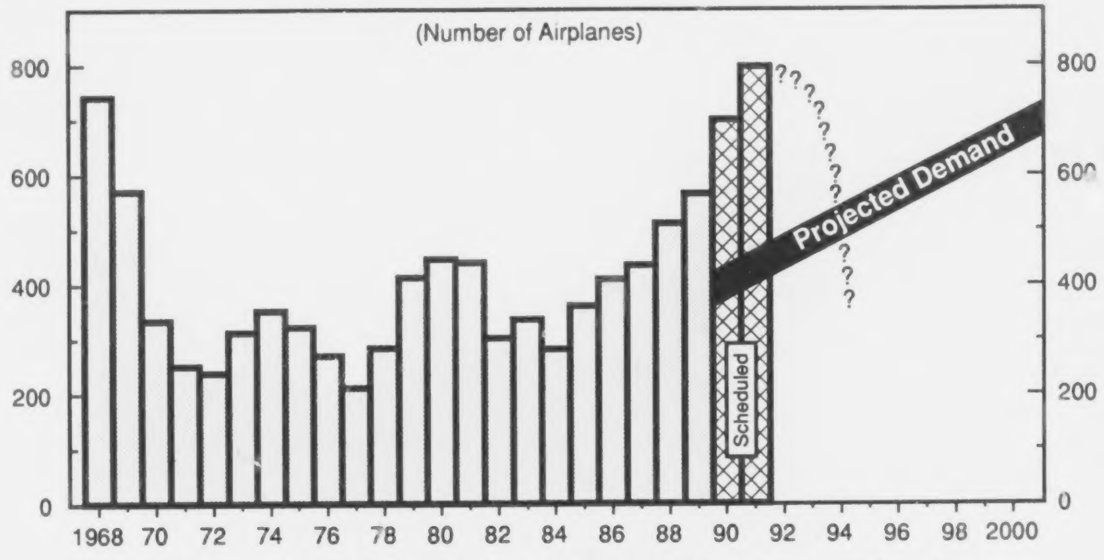
	1930	1989
Per Capita Output (U.S. 89$)	$ 3,700	$ 1,800
World Ranking	7th	70th
Economic Growth (annual rate, 10 years ending)	5%	-0.8%
Inflation Rate	2%	4923%
Government Spending (% of GDP)	11%	45% ('88)

Data compiled by ALPHA Estudio de Economia y Negotios S.A., Buenos Aires.

Comment: These data show the dramatic consequences of sixty years of political and economic mismanagement, proving again the adage that Argentina was "blessed by nature but condemned by ideology."

Present Boom, Coming Bust

Commercial Aircraft Deliveries



Note: Projected demand based on an expected 6 percent per year trend growth for world air travel.

Comment: Commercial aircraft manufacturers around the world are enjoying good times these days. New orders are flooding in. Production is at full capacity. Profit margins are gratifyingly high. And unfilled order backlogs are at levels that appear to guarantee continued prosperity for years to come. But watch out! As the manufacturers themselves realize, it is too much of a good thing. Much too much! The frenzied ordering by the airlines has pushed current levels of production far beyond the long-term needs of the industry. Indeed, almost twice as many planes are to be delivered next year as called for by reasonable estimates of long-term travel growth. Sometime after 1991, then, aircraft production will have to return to reality. Today's boom, inevitably, will become tomorrow's bust. Let's hope it's not as painful for the manufacturers and their suppliers as the 1968-72 cycle proved to be.

Quotable Quotes

Baseball and Imperial Overstretch

By George F. Will

GEORGE F. WILL
MEN AT WORK

The national pastime is better than ever in almost every way and is getting even better every year. The same can not be said about the nation. America consumes too much and saves too little. Indeed the nation's savings rate, the worst among industrial nations, is a scandal because it is a choice: Public policies contribute to it. Small savings and huge government deficits cause underinvestment, which causes slow growth of productivity, which produces economic anemia and uncompetitiveness. Increasingly we are being outperformed by—and even owned by—our competitors. We should be chagrined, but not surprised. They are studying harder and longer, and working harder and longer and better than we are. From a population approximately one-half the size of ours, Japan is producing an equal number of engineers. In 1985, 55 percent of U.S. doctoral degrees in engineering were awarded to foreign nationals, many of whom went home. In the late 1980s about half the Ph.D.s being hired in the high-tech electronics industry were foreign born. We produce 35,000 lawyers a year. Japan muddles through with only a fraction of that depressing total. American children spend 180 days in school, Japanese children spend 240 days and the school days are longer. Japanese students outperform American students in math, science and engineering. American children outperform Japanese in English. For now.

Such facts have given rise to a spate of analyses, the theme of which is that America's problems are the result of "imperial overstretch," a national impulse to try to do too much abroad. I believe America's real problem is individual understretch, a tendency of Americans to demand too little of themselves, at their lathes, their desks, their computer terminals. The baseball men I have spent time with while preparing this book demonstrate an admirable seriousness about their capabilities…If Americans made goods and services the way [Baltimore shortstop] Ripken makes double plays, [San Diego outfielder] Gwynn makes hits, [Los Angeles pitcher] Hershiser makes pitches and [Oakland manager] La Russa makes decisions, you would hear no more about the nation's trajectory having passed its apogee.

(Excerpted from George F. Will, *Men at Work — The Craft of Baseball*, Macmillan, New York, 1990.)

Europe and America: Who's Number One?

By Ben J. Wattenberg

In the 1980s it was said that Japan and Europe were in ascendant phases and that America would no longer be number one, whatever that meant. No nation or group of nations can be dominant in the modern world unless it is technologically advanced, populous, prosperous, market-oriented, freely governed, and militarily secure. Japan, for all its economic might and technological achievement, is not. It is the most rapidly aging country in the world, a distant island defended by the United States. It is not in the running for global superpower. That leaves Europe and the United States.

Let us assume the best and hope all good things happen in Europe. By the year 2000, Eastern and Western Europe will have come together in a loose political union with freedom, markets, and a common currency. It will still have nineteen different national tongues, different cultural and religious traditions, and a shrinking population.

There will be continued illegal immigration to the Continent from Africa and Asia and vigorous efforts to resist it. The result may be the worst of two worlds: small population gains and great internal tension.

While Europe and Japan will be declining, the United States will be growing. The babyboom infants of yesteryear are the mothers of today. Our country accepts more immigrants than the rest of the world and thus provides itself with a renewed infusion of intellectual dynamism. (Of the forty Westinghouse science scholarship winners in 1990, nineteen were Asian-American.)

There is only one modern, growing, stable, large, democratic, capitalist nation with a close-to-perfect investment climate: the United States. In the years to come, American values will continue to play a leading role in the emerging free world.

(Excerpted from Ben J. Wattenberg, *The First Universal Nation: Leading Indicators and Ideas About the Surge of America in the 1990s*, forthcoming. Ben Wattenberg is Senior Fellow at the American Enterprise Institute.)

Albert T. Sommers' Statistical Insight

The U.S. International Investment Position

Albert T. Sommers
Senior Fellow and
Economic Counsellor
The Conference Board

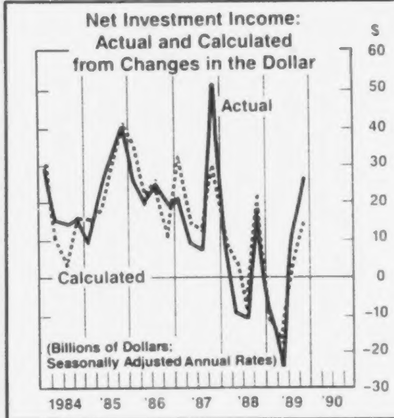
In all the bewildering array of statistics on the U.S. net international position, the most widely publicized figure points to a massive U.S. international indebtedness — that is, an excess of foreign investment in the United States over U.S. investment abroad. The standard accounting for this international balance sheet tells us that as a consequence of persistent large deficits in the U.S. international accounts, and therefore persistent growth in foreign holdings of dollars, the net investment position of the United States has swung from about a $100 billion surplus at the beginning of this decade to about a $600 billion deficit today.

This accounting seems to be inconsistent with the fact that U.S. earnings from its investment abroad have persistently exceeded earnings of foreigners on their investment in the U.S. The net earnings balance has subsided, but it was slightly positive even in 1989. How come? Well, for one thing the U.S. net indebtedness is not as big as it looks; for another, its net earnings are not as good as they look.

All of these statistics have prominent wrinkles in them, wrinkles that should be straightened out to achieve a clearer picture of what's at work in the international investment market. In the first place, the net indebtedness of the United States, as shown in the standard table, is open to one major correction. The direct investments in both the U.S. account and the foreign account are expressed in terms of book value; but the U.S. investment abroad is, on average, much older, and its appreciation over time (which is unrecognized in the accounts) is doubtless much greater than the comparable appreciation for foreign investment in the U.S. If the two sets of figures were converted from book value to current-market value, the statistical scholars on this subject argue that the U.S. net investment position would be increased by as much as $500 billion. Such an adjustment would nearly wipe out the net indebtedness, and would help to explain why the net earnings position has not subsided into substantial deficit.

But other factors that enter into the flows of earnings here and abroad suggest a less comforting conclusion. The U.S. excess of receipts of earnings over payments of earnings has in fact fallen very sharply since 1985, but the plunge has been periodically interrupted, now and then spectacularly, by sudden surges of income. This happened toward the end of each of the past 3 years. These surges of net earnings reflect the translation of profits earned by U.S. subidiaries abroad, at points in time when the dollar has weakened and therefore the earnings of these subsidiaries in foreign currencies translate into much higher earnings when expressed in dollars. The earnings balance has in fact deteriorated, and the deterioration is well revealed by the accompanying chart, which expresses the change in net investment income as a function of changes in the dollar, and time.

When we smooth the translation gains and losses, the change in U.S. net investment income is much clearer: It has been subsiding ever since the early 1980s, at an average rate of about $4 billion a year. This is not a big figure relative to the trade deficit, which is now running at about $100 billion a year. But the accumulating loss since the beginning of the decade has cost the U.S. international account about $40 billion — that is, the $40 billion annual surplus earned on net investment in the late 1970s has fallen to zero. Foreign investment in the United States has many favorable consequences; but the flow to foreigners of earnings on those investments is itself a source of weakness in the U.S. international current account now. And almost assuredly, it will continue to reduce our current-account balance for the next several years.

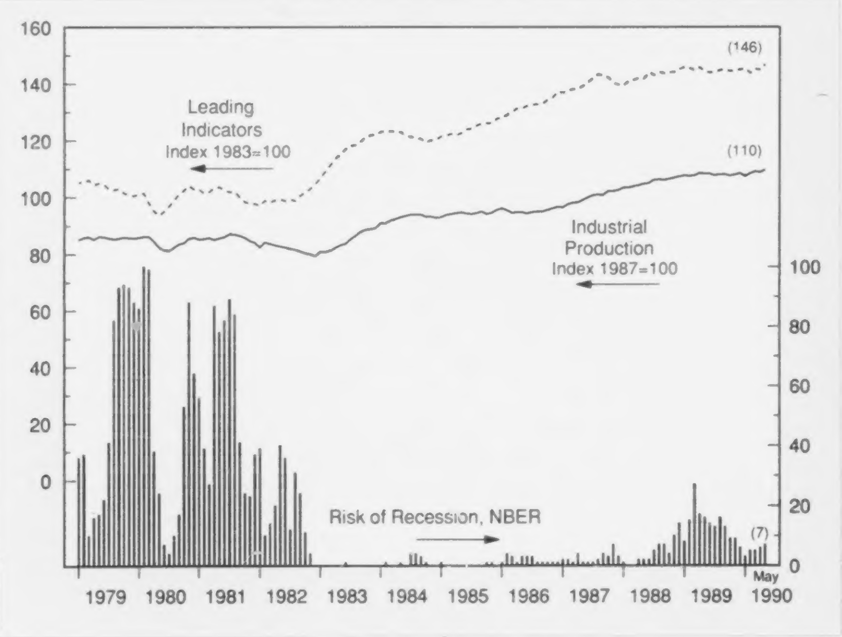


Equation:
$Y_c = 24.782 - 3.310x_1 - 1.040x_2$
$R = .880$
(Where x_1 = Exchange rate of the U.S. Dollar;
x_2 = Time; y = Net Investment Income)

Conference Board Stat File

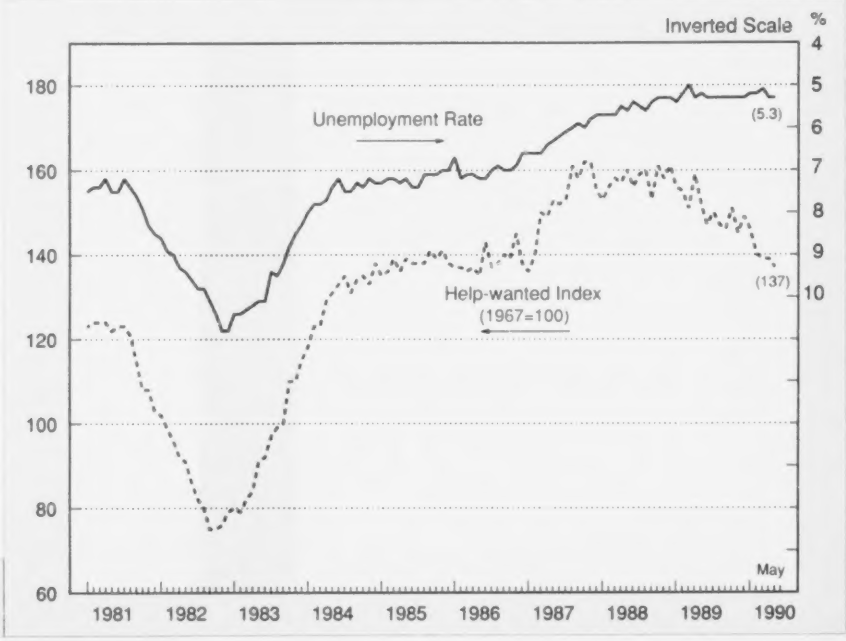
What's impressive about the economy is how much stability the statistics display *(discounting the usual short-term noise)* month after month, and thus how minutely the outlook changes. All journalists and most economists find this stability devastatingly frustrating, but it's been true for a year and a half and there's no sign of change this month either. We continue to look for 2 percent growth, 4-5 percent inflation, and fairly stable financial markets indefinitely, that is, until the business cycle awakes and rears its ugly head in one direction or the other. *(Note: Data for Conference Board series in this section are available upon request to Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Economy advancing slowly. Recession chances remote.

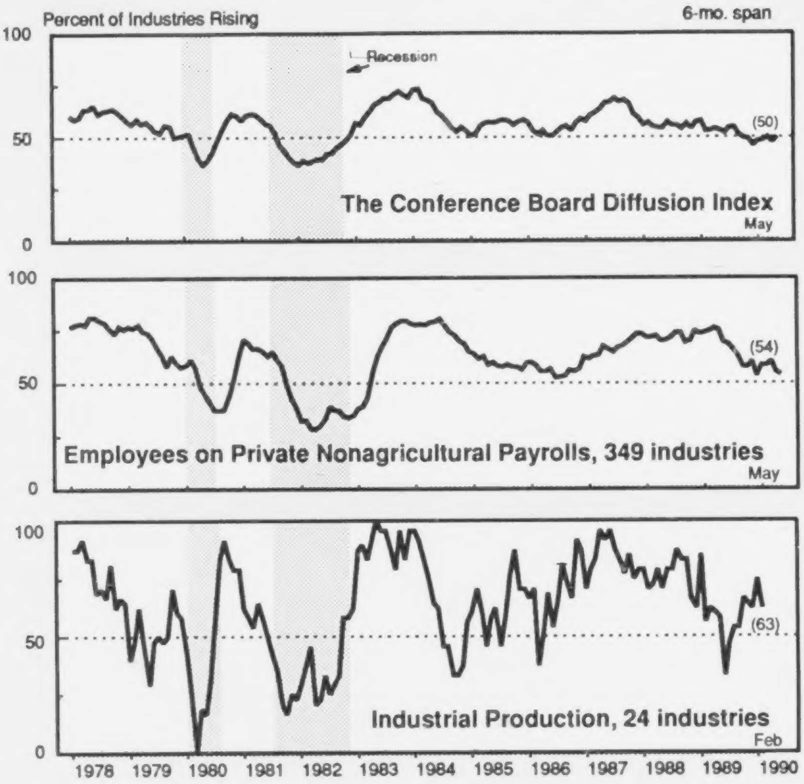
Help-wanted Advertising and Unemployment



Labor demand softening.

Conference Board Stat File

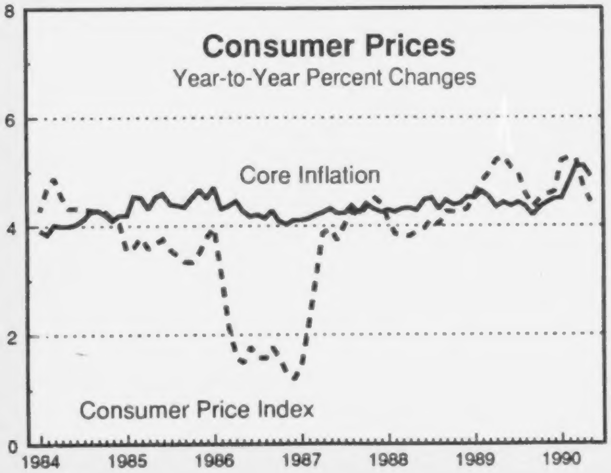
Indexes of Economic Momentum



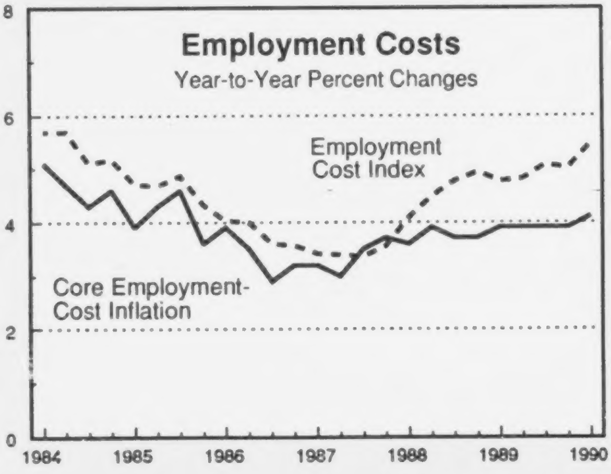
Momentum holding slightly above the water line.

Just a hint of acceleration.

Inflation Fundamentals



Core inflation = CPI excluding food at home and energy

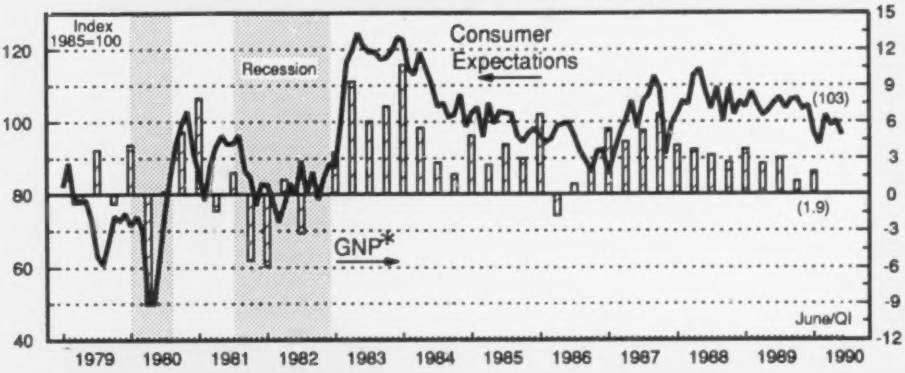


Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

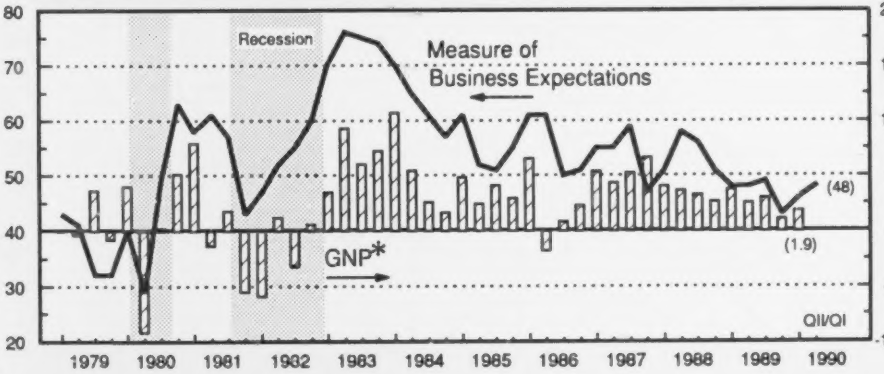
Conference Board Stat File

Confidence

Conference Board Consumer Expectations Index



Conference Board Measure of Business Executives' Expectations

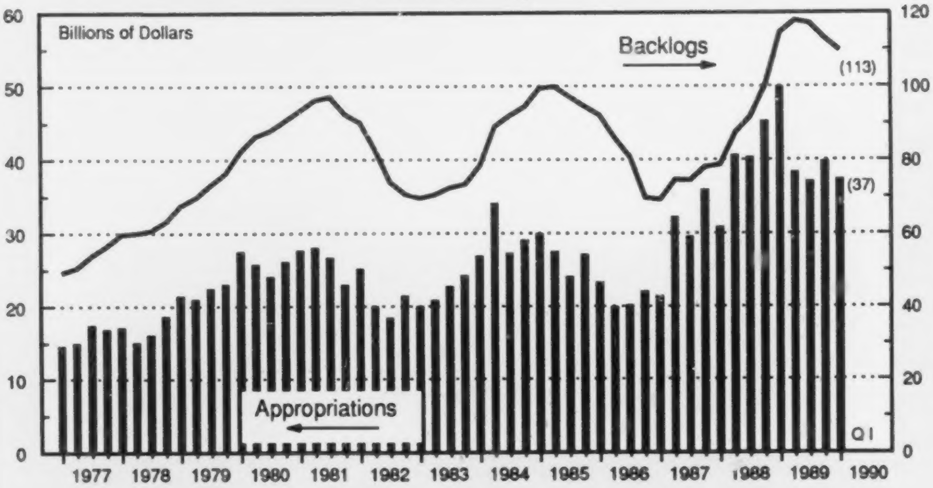


* Quarterly percent changes in GNP at annual rates

Both measures still consistent with slow economic expansion.

Investment Intentions

Conference Board Capital Appropriations
Manufacturing



Both series signal some loss of energy in manufacturers' capital expansion plans.

Inside the Crystal Ball

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		May	May	May	May	May	May	May	May		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		%	%	%	%	%	%	%	%		
Actual	1989 4Q	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	4Q 1989	Actual
	1990 1Q	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1Q 1990	
Forecast	2Q	2.5	2.1	1.5	1.2	3.6	1.9	3.2	2.8	2Q	Forecast
	3Q	1.1	1.9	1.9	3.2	3.7	1.7	2.2	1.7	3Q	
	4Q	1.7	1.5	2.1	1.5	2.8	1.2	1.4	1.9	4Q	
	1991 1Q	2.6	1.7	2.1	3.1	1.8	1.8	2.7	2.5	1Q 1991	
	2Q	2.4	2.3	2.5	1.7	1.2	2.5	2.3	2.4	2Q	
	3Q	2.3	2.4	3.0	2.0	1.1	2.4	2.1	2.1	3Q	
	4Q	2.4	2.5	2.8	0.2	2.7	2.7	1.3	2.4	4Q	
	1992 1Q	2.5		3.1		3.8	2.9	1.9	2.4	1Q 1992	
	2Q	2.1		3.4		2.4	2.6	2.2	2.3	2Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

Actual	1989 4Q	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	1989 4Q	Actual
Forecast	1990 4Q	4.5	4.4	4.1	4.3	4.8	4.3	4.0	4.4	1990 4Q	Forecast
	1991 4Q	4.1	4.2	3.9	4.3	4.7	4.0	4.0	4.1	1991 4Q	

Unemployment Rate

(Percent, quarterly)

Actual	1989 4Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	4Q 1989	Actual
	1990 1Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	1Q 1990	
Forecast	2Q	5.6	5.3	5.4	5.4	5.3	5.5	5.4	5.5	2Q	Forecast
	3Q	5.8	5.4	5.4	5.4	5.3	5.6	5.3	5.7	3Q	
	4Q	5.9	5.5	5.5	5.4	5.3	5.8	5.4	5.8	4Q	
	1991 1Q	5.9	5.5	5.6	5.5	5.3	5.8	5.4	5.8	1Q 1991	
	2Q	5.9	5.4	5.5	5.6	5.3	5.8	5.4	5.8	2Q	
	3Q	5.9	5.4	5.4	5.6	5.3	5.8	5.4	5.8	3Q	
	4Q	5.8	5.4	5.3	5.5	5.3	5.8	5.5	5.7	4Q	
	1992 1Q	5.7		5.2		5.3	5.7	5.5	5.6	1Q 1992	
	2Q	5.7		5.2		5.3	5.7	5.5	5.6	2Q	

The Conference Board
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The Conference Board

Volume 1, Number 4 September 1990

Economic Times

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- **Why are Women Paid Less?** *(pages 4-5)*
- **Moscow and New York: Not so Different After All.** *(page 6)*
- **Dr. Noitall on Why 2+2=5.** *(page 7)*
- **The Crystal Ball** *(page 11)*

Editors Note:

The big issue at the moment is the impact of the Middle East crisis, which we address on this page and the next, and with the chart on page 8. We also focus on an important and highly controversial issue that's been festering for decades, why women are not compensated at the same level as men. I'm sure Victor Fuchs' superb analysis is not going to satisfy all our readers. Then we present an intriguing little story comparing public attitudes in Moscow and New York. Finally, you should get a grin or two from Dr. Noitall's advice on how economists can improve their public image.

Quip of the month:

James M. Howell, explaining why he retired as Chief Economist of the Bank of Boston:

Twenty-eight years of wrong forecasts is enough!

From Slam Dunk to Double Gainer

Q: *What has Saddam Hussein done to the business outlook?*

A: Weakened it noticeably, throughout the industrial world. The hike in oil prices raises the inflation rate and reduces economic activity, as we learned the hard way, twice, in the 1970s (chart, p.8). The widespread fear of serious economic troubles or even war curbs consumer buying. The Conference Board's consumer survey says this may be happening now (chart, p.10).

Q: *So we're in a recession? That's what the stock and bond markets say, right?*

A: Not now. Stocks are pointing that way, true, but not bonds. Bond prices don't decline in recession. Yes, they would rise even in the face of a worsening inflation outlook. A recession dries up the demand for credit pretty fast.

Q: *But isn't recession imminent? We all remember the 1970s. Won't this crisis create a recession before long?*

A: The parallel between the 1970s and the 1990s is far from exact. This time the oil price hike is much smaller. And since we've been through the shock twice before, maybe it won't jolt our collective psyches so badly this time. There's been no panic buying of gasoline thus far.

Q: *So you rule out a recession?*

A: I don't rule it out, not at all, but for now my nickel bet is against it. Before the crisis, the economy wasn't growing vigorously, but it was doing reasonably well. I don't accept the "spinning top" theory of the business cycle, which assumes that any slowing of the expansion will lead, inevitably and forthwith, to the economy tipping over into recession. Thus even though the outlook has weakened and growth is slower, that doesn't guarantee recession.

Q: *Come on, give us a precise forecast!*

A: OK. Previously I was looking for 1 or 2 percent growth for the year ahead, now I'm guessing half that. It's not much, but it's still a plus, and thus a lot different from a recession. But our faith in all forecasts has fallen steeply. Six months ago the forecast of continued growth was a slam dunk. Now that the risk of recession is nearly even money, my slow-growth forecast is a double gainer from the tuck position with a half twist. (Forgive the mixed metaphor, please.)

Q: *What about inflation?*

A: About 5 1/2 percent, but the ongoing gradual acceleration of the inflation rate shouldn't continue for too long. And this is pretty much a neutral cyclical climate for interest rates, too — no reason they should move sharply either way.

Q: *And the budget?*

A: That's easier than usual. Nothing will be done about the deficit, except to defang Gramm-Rudman-Hollings. The heightening of economic risks gives both Congress and the Administration the excuse they were looking for to avoid, yet again, making difficult budget decisions.

Q: *Finally, can the economic blockade of Iraq be effective?*

A: Given enough time and near unanimity of effort, yes, very much so. But don't expect quick results. The lessons of economics are that more alternative sources of supply and more substitutes are always available than you ever thought possible. So the fact that Iraq has only two weeks inventory of corn on hand is not an important indicator of its capacity to survive a blockade. Should Iraq capitulate soon, it'll probably be from a feeling of isolation, rather than any direct effect of the blockade.

Edgar R. Fiedler

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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Colloquium

Background:

Because the jump in oil prices will raise the inflation rate and curtail economic activity, the Middle-East crisis has been universally interpreted as a setback for the economy. Whether this will prove to be a serious setback or just a minor crimp is, however, being widely debated. As a result, there is also talk that whatever resolve Congress and the White House may have felt a month or two ago to make major long-term inroads on the budget deficit, that resolve is now fading away.

Question:

In view of the new uncertainty about the economic outlook, do you believe that it is now a good idea to postpone or scale back any budget belt-tightening?

Lyle E. Gramley
Mortgage Bankers Association

If the world price of oil stays in the high $20s, the increase in the U.S. oil bill will be around $60 billion, or 1 1/4 percent of GNP. Adding another $50 billion in budget restraint now would push the economy into recession. But the need for long-term deficit reduction is no less urgent, and the argument for an energy tax is more compelling than ever. A phased-in energy tax, building to $100 or $150 billion annually five years from now, would be good bugetary policy, good energy policy, good environmental policy, and good foreign policy.

Murray Weidenbaum
Center for the Study of American Business

Of course we should put the Federal Government on a diet. A soft economy is the wrong time for tax increases *(is there a right time?)*. But reducing government waste always helps achieve a more productive economy. Every department has spending programs that flunk the simplest benefit-cost test. Why use private saving to finance such boondoggles? Let the funds remain in the private sector, where they may give the economy a lift.

Robert G. Dederick
Northern Trust Company

What this country needs is markedly lower real interest rates. The expansion has run out of gas *(not literally)*, and it needs a refill — in the form of an easier monetary policy. But, as Alan Greenspan has learned, the Federal Reserve must have a justification for action that will be convincing to the bond markets. Otherwise they will rebel. What could provide better cover for a large Fed move than a tightening of the budget? I'm all for it.

Laura D'Andrea Tyson
University of California, Berkeley

The budget talks are the hostage of Saddam Hussein. With gasoline taxes and defense reductions ruled out, a budget compromise is a fantasy. Perhaps we should breath a sigh of relief. Fiscal austerity is risky business when demand is weak and when the Fed, spooked by inflationary pressures and jumpy financial markets, may be unable or unwilling to take up the slack. Under current conditions, caution is the better part of valor. Budget talks should continue but actual cutbacks should be postponed until the economy strengthens.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Director, Economic Studies Program, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Why Are Women Paid So Much Less?

By Victor R. Fuchs

Perhaps most women have experienced some discrimination by some employer at some point in their careers.

The available data suggest that marriage and children handicap women's efforts to earn as much as men.

The past quarter-century has witnessed extraordinary changes in gender roles and relationships. Yet amidst all this ferment there is another story — the persistence of large differences in sex roles and circumstances. Overall, women have made no gains in economic well-being (relative to men) since 1960.

The persistence of substantial gender inequality a quarter-century after the passage of major antidiscrimination legislation and several decades of massive social change poses a major problem for economic analysis and policy. Why are women at an economic disadvantage relative to men, and why is it so difficult for them to improve their relative position? The most popular answer — prejudice and exploitation by employers — is seriously incomplete. There is undoubtedly some prejudice and some exploitation, but the evidence in support of the employer explanation is weak and there are many facts about work and wages that are inconsistent with it.

The wage gap between women and men is very large even within detailed census occupations. Most white men and women (74 percent) are employed in occupations in which the women/men wage ratio is between .50 and .69 (chart, left panel). How is it possible for the wage gap between women and men to be so large within occupations when equal pay for equal work is the law of the land? One answer is that the Census occupations frequently include heterogeneous groups of workers, many of whom have different jobs.

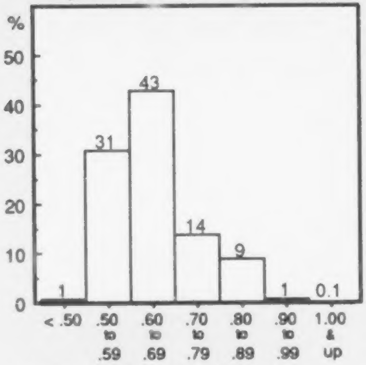
No doubt many women, perhaps most women, have experienced some discrimination by some employer at some point in their careers. Destructive as these acts may be for individual women, however, they do not explain the huge wage gap between women and men in the aggregate. Consider the fact that millions of workers, both men and women, do not have their wages determined by employers at all: their earnings depend upon self-employment income, commissions, tips, piece rates, and other forms of compensation closely tied to individual performance. The sex difference in hourly earnings of the self-employed is actually larger than among regular wage and salary employees.

The claim that the wage gap results from employer discrimination is based primarily on indirect evidence. The typical study takes a sample of male and female workers and attempts to explain their individual earnings by their individual characteristics such as years of schooling, years of work experience, and so on. Most often, the characteristics used in the study explain only about half of the difference in earnings between women and men. The unexplained portion is then attributed to employer discrimination.

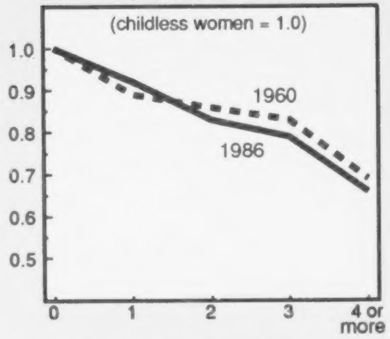
Is this a reasonable inference? Probably not. Consider an analogous attempt to explain sex differences in mortality. Suppose we took a sample of men and women who had died in a given year and attempted to explain variation in the age of death by individual characteristics such as cigarette smoking, education, income, and the like. Most of the seven-year gap in age of death between men and woman would remain unexplained. Would we be justified in attributing the unexplained differential to discrimination against men by physicians and hospitals? Surely not. The statistical analysis shows that some individuals die sooner than others because they are men, but it does not tell us why. The explanation probably lies in some variables (for example, hormones, stress) that were not included in the analysis, but the exact reasons for the sex gap in mortality are not known. Similarly, the analysis of wages shows that some individuals earn less than others because they are women, but it doesn't tell us why.

Sources of Inequality

The difficult but central question is, "What is it about being a woman that leads to lower earnings?" The available data suggest that marriage and children handicap women's efforts to earn as much as men, and that success in paid work usually requires great sacrifices by women. The conflict between family and career is much greater for women than for men, and the persistence of that conflict continues to frustrate women's quest for economic equality.


Distribution of Workers by Women/Men Wage Ratios

Women/men Wage Ratios, Whites Only, Within Occupations, 1980


Relative Hourly Earnings of Women by Household Size

Number of Children in Household. (Whites Only, Ages 30-39, Earnings Adusted for Age and Education)

The tremendous impact of marriage and related homemaking responsibilities on women's wages is evident in a comparison of the hourly earnings of married and unmarried women at different ages. In their early twenties married women actually earn slightly more than the unmarried, but their relative position deteriorates rapidly as they get older and their home responsibilities increase. By the time they are in their 40s, married women make only 85 percent as much as unmarried women per hour of work.

Children depress women's wages for several reasons (chart, right panel). First, many women leave the labor market during pregnancy, at childbirth, or when their children are young. These child-related interruptions are damaging to subsequent earnings because three out of four births occur to women before the age of 30—the same time that men are gaining the training and experience that lead to higher earnings later in life. Second, even when mothers stay in the labor force, responsibility for children frequently constrains their choice of job: they accept lower wages in exchange for shorter or more flexible hours, location near home, limited out-of-town travel, and the like. Third, women who have disproportionate responsibility for child care and housework often have to make sacrifices in their market work. For instance, when a young child is present, women are more likely than men to be absent from work, even at equal levels of education and wages. Perhaps most important of all, because most young women expect to be mothers, they (and their parents) are less likely than men to invest in wage-enhancing human capital while in school and in their first job or two after leaving school.

Even childless women earn substantially less (about 20 percent) than men, but part of that differential can also be attributed to the fact that women bear children. When these women were young, most of them did not know that they would be childless, and the subjects they studied in school as well as the jobs they had upon leaving school probably did not differ much from those of other women. Similarly, prospective employers were unlikely to know which young women would have children and which would not. This uncertainty could affect the employer's willingness to provide training opportunities or to make other investments in job-related human capital. The main point is that at the ages when crucial decisions must be made about education and early job choices, most women do not know how many children they will have, to say nothing of the timing of those births.

In summary, despite major antidiscrimination legislation and significant social change, most women have not improved their economic well-being relative to men over the past quarter-century. This conclusion does not apply to women who are white, unmarried, young, and well-educated: they gained about 10 percentage points relative to their male counterparts. Discrimination by employers undoubtedly contributes to women's economic disadvantage, but the conflict between career and family appears to be more important and pervasive. This conflict bears more heavily on women than men because women's desire for children and concern for their welfare appears to be, on average, stronger than the men's. Thus child-centered policies to help women are likely to be more effective and efficient than labor market interventions, and child allowances financed by broad-based taxes are likely to be superior to restricted eligibility financed by so-called "employer-provided" programs.

Excerpted from "Women's Quest for Economic Equality," *Journal of Economic Perspectives* — Volume 3, Number 1 — Winter 1989. Victor R. Fuchs is Henry J. Kaiser Jr. Professor at Stanford University and a Research Associate with the National Bureau of Economic Research

Attitudes in Moscow and New York: More in Common than You Think

A telephone survey of slightly more than 100 citizens of Moscow and an equal number of New York area residents, conducted in May 1990, compared the economic attitudes of the two peoples. A main purpose of this study was to test the hypothesis, one heard frequently in the Soviet Union and elsewhere recently, that the soviet people will not accept a market system, either because they lack experience with such a system or because their personal values are inconsistent with it.

The survey results revealed some significant attitudinal differences between Muscovites and New Yorkers, some in the expected direction. Attitudes toward business success, for example, were not as warm in Moscow. And Muscovites were more willing than New Yorkers to have government put a limit on price increases, even though it might create a shortage.

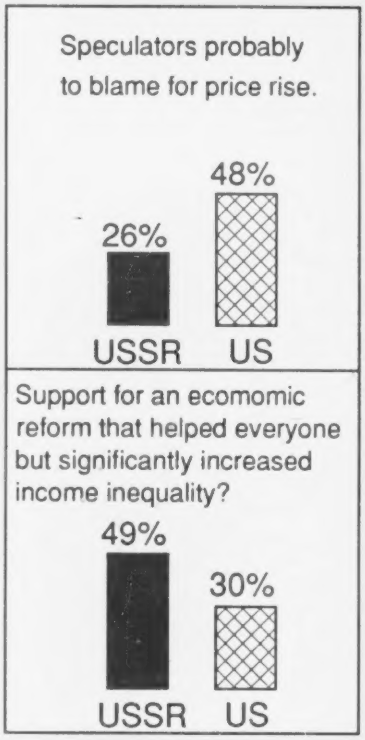
But some differences in attitudes were surprising. New Yorkers were more likely to think "speculators" cause price increases and create shortages, and they were not as willing to support an economic reform that would create income inequalities.

The differences notwithstanding, the dominant theme of the survey results was the similarity found in the opinions and values of the peoples in the very different cultures. The two groups held pretty much the same views about the unfairness of price increases, the moral acceptability of profits, their willingness to impose rationing to reduce gasoline consumption rather than to clear the market by levying a tax to raise prices, their belief in the importance of material incentives, and their reasons for savings. Probably the most striking similarity is found in a question about inheritance taxes: Asked what inheritance tax rate should be paid by "really wealthy" people, the median rate was very close, 34 percent in Moscow, 30 percent in the New York area.

The lack of significant contrasts in popular attitudes between the citizens of the two metropolitan areas casts doubt on the widely held idea that the Soviet peoples are unwilling or unable to adapt to a market economy. As the report's authors say, "The surprise here is that often Americans seem as 'socialist' as the Soviets, and the Soviets as 'capitalist' as the Americans."

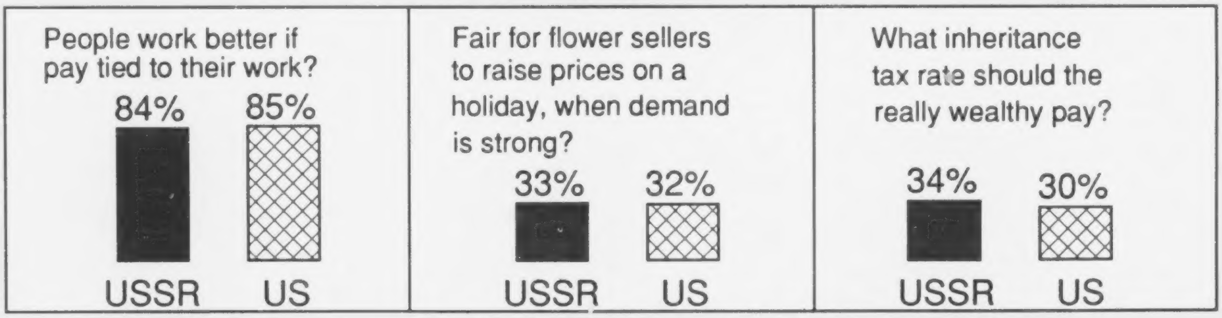
Summarized from *"Popular Attitudes Towards Free Markets: The Soviet Union and The United States Compared,"* by Robert J. Shiller, Yale University, and Maxim Boycko and Vladimir Korobov, U.S.S.R. Academy of Sciences, a working paper, forthcoming, from the U.S. National Bureau of Economic Research.

Surprising Differences


Speculators probably to blame for price rise.

Support for an ecomomic reform that helped everyone but significantly increased income inequality?

Interesting Similarities


People work better if pay tied to their work?

Fair for flower sellers to raise prices on a holiday, when demand is strong?

What inheritance tax rate should the really wealthy pay?

Restoring the Reputation of Economists

An Interview with Dr. Noitall, the world's greatest public-relations authority.

Economic Times: *Why do economists have such a poor image?*

Dr. Noitall: How can you ask such a simple-minded question? You, the people who brought us unemployment, inflation, poverty, energy shortages and other major social afflictions!

ET: *But we are not in favor of those conditions. We only point them out, and explain how to deal with them.*

Dr. Noitall: That shows your naivete. The Bible records the execution of messengers who brought bad news. We no longer execute such people, but we certainly don't have to like them. You tell me I have to give up my air-conditioned gas guzzler for a crowded, four-cylinder, nondescript vehicle, and expect me to like you!

ET: *But it's our job to tell people when 2 + 2 = 4.*

Dr. Noitall: That's exactly where you are wrong! A recent poll shows that more than half the people think 2 + 2 = 5, and every network agrees with them. Those people have rights, they believe sincerely that 2 + 2 = 5, and you take no account of their wishes and desires. Simply imposing 2 + 2 = 4 on them is not democratic.

ET: *But there is really no serious scientific disagreement on the question.*

Dr. Noitall: That is exactly the problem! The Establishment is lined up monolithically on the side of 2 + 2 = 4. A dissident economist representing the 2 + 2 = 5 school cannot get his articles published in prestigious journals. Peer review is unwilling to look with favor on such viewpoints. Granting agencies do not invite people who believe 2 + 2 = 5 to serve on their boards.

ET: *We can't take seriously people who make emotional rather than scientific arguments.*

Dr. Noitall: That reflects a condescending attitude toward those who did not have the privilege of an advanced education. Prominent political groups have already supported enactment of legislation, even if it is scientifically inaccurate, as long as the public wants it.

ET: *Then how can we go about changing public opinion?*

Dr. Noitall: In the first place, stop having funny-looking people in glasses appearing on television and before legislative committees. Pick real successes, such as actors, actresses, and rock singers, and let them present your side of the story. Making large amounts of money and being handsome is evidence of success in modern society. Such people are much more likely to understand big subjects than professional economists. And stop defending unpopular causes. It is now understood that unemployment is bad. Saying it's all right in small doses will only get you an image as an apologist for bad guys.

ET: *But even if we pick attractive spokespersons, how can we convince them of the truth?*

Dr. Noitall: That is another misconception you will have to get rid of. There are two truths in this world: one of the profession, and the other of the media. What people perceive as the truth is truer in a democracy than some grubby little calculation on a computer. A stubborn insistence on the facts instead of people's perception of the facts makes you look heartless and disdainful. You will have to come out as more reasonable and accommodating, as more benevolent, kindly, and pliable, willing to give and take, empathizing with the public's fears and frustrations.

ET: *So how do we handle the 2 + 2 = 4 problem?*

Dr. Noitall: Start by conceding that 2 + 2 = 4 1/2!

by **Daniel E. Koshland, Jr.**
Adapted from *Science*, 23 March 1990.

Quotable Quote

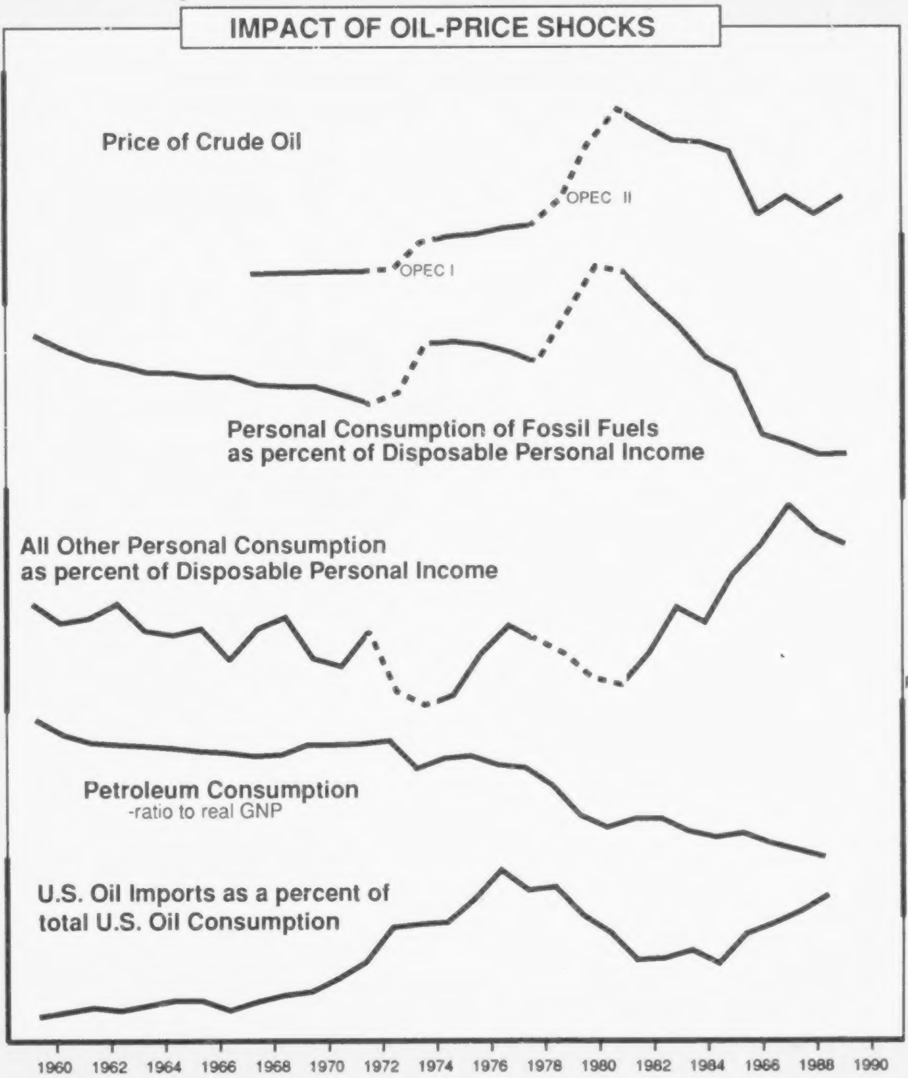
Thomas J. Plewes
Associate Commissioner of the Bureau of Labor Statistics,
Discussing criticisms of economic statistics:

The main problem may not be so much the declining quality of the data as the ever-increasing demand for information from data-hungry users. For example, a foreign bond-trading house complained about the amount of time it took to get access to our data after release. Thinking that they were talking about the slowness of the mail, we suggested that they subscribe to the electronic-press-release service. They said that they already did, but it took 2 minutes to get the data — was there some way we could speed it up?

Conference Board Stat File

The dramatic increases in oil prices *(top series plotted below)* in 1973 and 1979 — events now known as OPEC I and OPEC II — proved to be great shocks to the energy-intensive American economy. For a time, consumers cut back sharply on their non-energy spending (3rd series), partly out of shock, and partly because the extra costs of buying energy *(2nd series)* left them with less purchasing power to spend on other items.

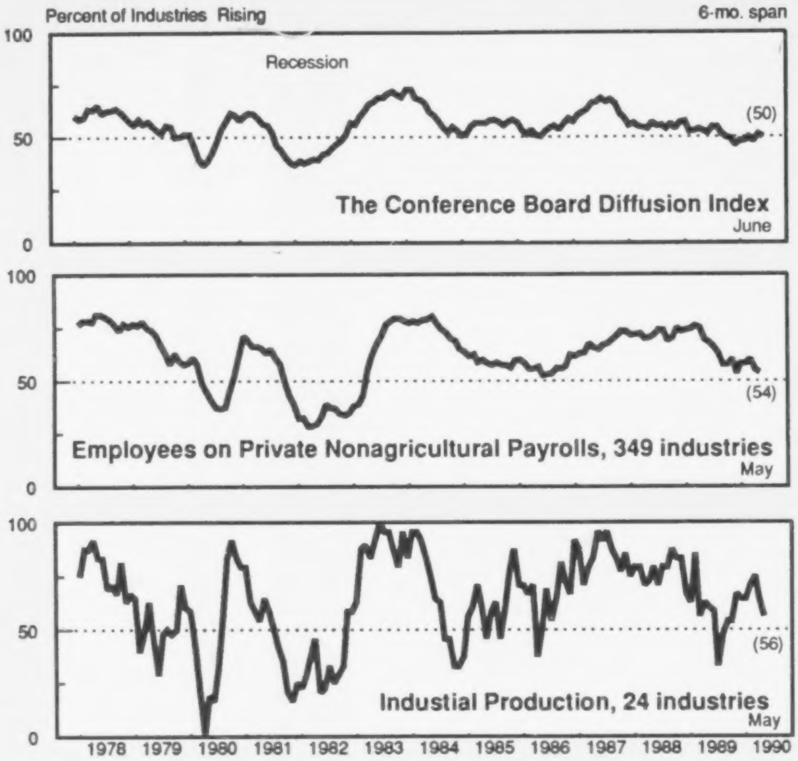
Over the long haul, Americans improved their energy efficiency substantially *(4th series)*, mostly because of higher *(relative)* energy prices but also as a result of regulatory mandates, notably on gasoline consumption by automobiles. Nevertheless, because oil demand grows with the economy and because domestic oil production is declining, oil imports *(bottom series)* again account for about half of total U.S. oil consumption, increasing our dependence on and our vulnerability to the OPEC cartel. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*



Source: U.S. Department of Energy

Conference Board Stat File

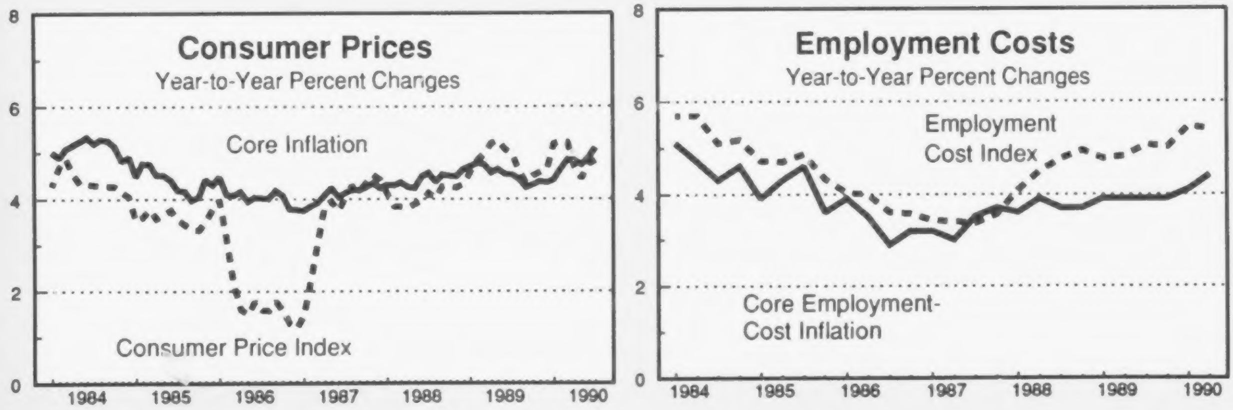
Indexes of Economic Momentum



Economic momentum neither fading nor recovering.

Gradual acceleration continues.

Inflation Fundamentals



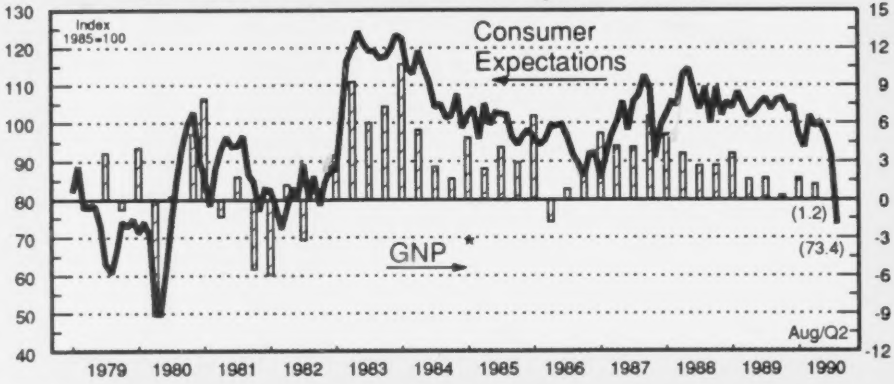
Core inflation = CPI excluding food at home and energy

Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

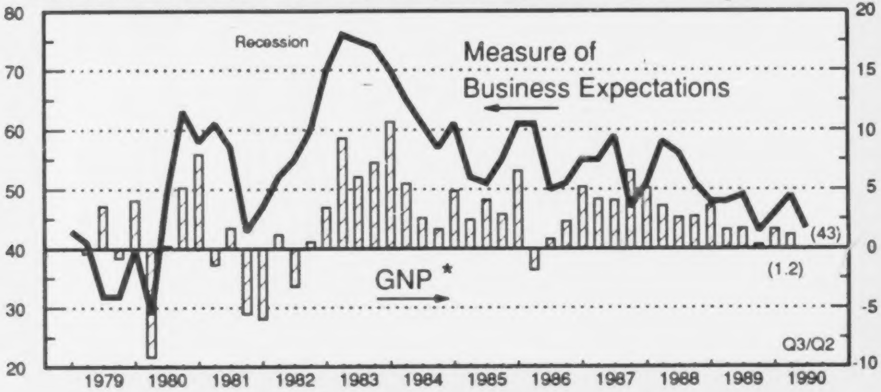
Conference Board Stat File

Confidence

Conference Board Consumer Expectations Index



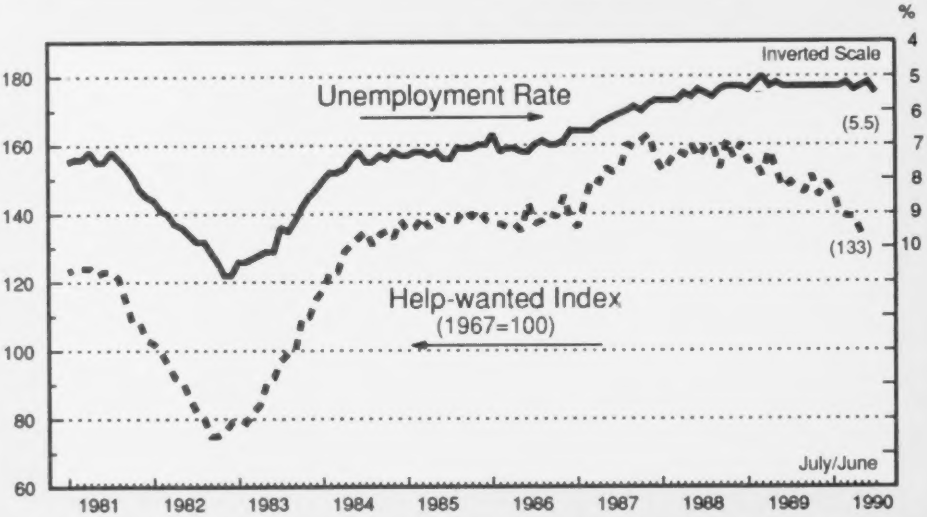
Conference Board Measure of Business Executives' Expectations



* Quarterly percent changes in GNP at annual rates

New oil shock rocks consumers.

Investment Intentions



Labor demand continues to soften.

Inside the Crystal Ball

	UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA
Date of Forecast	Aug	Aug	Aug	Aug	Aug	Aug	Aug	Aug

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%	%	%	%	%		
Actual	1990 1Q	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1Q 1990	Actual
	2Q	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	2Q	
Forecast	3Q	-3.5	1.2	1.4	1.0	1.6	1.1	0.2	-1.5	3Q	Forecast
	4Q	-3.3	1.0	1.3	-0.7	2.5	-2.8	-0.1	0.8	4Q	
	1991 1Q	0.1	1.3	1.8	-0.4	2.2	-1.6	1.0	1.0	1Q 1991	
	2Q	3.3	2.2	2.9	-1.1	1.2	0.0	1.8	1.6	2Q	
	3Q	4.3	2.4	3.0	5.2	1.0	0.7	2.9	1.9	3Q	
	4Q	5.2	2.5	3.1	2.2	3.1	2.0	2.0	2.4	4Q	
	1992 1Q	4.5		3.3		4.5	2.9	2.6	2.5	1Q 1992	
	2Q	2.8		3.4		2.4	2.7	2.5	2.1	2Q	
	3Q									3Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	1989 4Q	Actual
Forecast	1990 4Q	4.5	4.5	4.2	4.9	4.4	4.6	3.9	4.6	1990 4Q	Forecast
	1991 4Q	3.4	4.3	3.9	4.2	4.7	3.9	4.2	4.2	1991 4Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1990 1Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	1Q 1990	Actual
	2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q	
Forecast	3Q	5.9	5.4	5.4	5.5	5.5	5.4	5.6	5.2	3Q	Forecast
	4Q	6.4	5.6	5.5	5.8	5.5	5.9	5.9	5.2	4Q	
	1991 1Q	6.8	5.6	5.6	5.9	5.5	6.3	6.1	5.2	1Q 1991	
	2Q	6.9	5.5	5.5	6.2	5.5	6.6	6.2	5.2	2Q	
	3Q	6.8	5.5	5.4	6.2	5.4	6.9	6.2	5.1	3Q	
	4Q	6.5	5.5	5.3	6.3	5.5	7.0	6.2	5.1	4Q	
	1992 1Q	6.2		5.2		5.5	7.0	6.1	5.1	1Q 1992	
	2Q	5.9		5.2		5.4	6.9	6.1	5.1	2Q	
	3Q	5.7		5.2		5.4			5.0	3Q	

The Conference Board
845 Third Avenue
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The Conference Board

Volume 1, Number 5 October 1990

Economic Times

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- **New Industry Outlook Report** *(center section)*
- **Colloquium on New Auto Mileage Requirements** *(page 3)*
- **The Economics of War** *(pages 4-5)*
- **Power to the People** *(page 6)*
- **The Crystal Ball** *(page 11)*

Editor's Note

This month we introduce a new feature I'm sure you'll like: an *Industry Outlook Report* (You'll find it on the shaded paper in the middle of this issue.) It includes brief analyses prepared by highly qualified industry analysts on the current outlook for seven different industries. In the future we will include these reports in the first month of each quarter, rotating among a total of about 20 different industries.

The common denominator of the other articles this month is unconventionality. First, you'll find Carl Kaysen's fascinating ideas on the probability of major wars — a very out-of-the-ordinary application of economic principles. Kaysen is followed by Ben Stein's revealing look at how dramatically everyday life has changed over the centuries. Finally, we offer a couple of the strong-minded and perhaps somewhat contentious views of Thomas Sowell. Enjoy!

Maxim of the month:

Ask five economists and you'll get five opinions — six if one went to Harvard.

How to Clean More Windshields

The big jump in gasoline and fuel-oil prices brought on by the Middle East crisis has — understandably — angered consumers and — predictably — evoked shrill complaints from politicians and self-appointed consumer advocates. The shrillest have been directed at "Big Oil." Michigan's Governor Blanchard, for example, said the price increases "reflect the stranglehold major oil companies have on the oil industry," and he introduced legislation "to break up the oil monopolies." A Minnesotan referred to "the thieves in the corporate board rooms of the oil companies." (Isn't it curious how the usually conservative Upper Midwest so often produces the most rabid anti-big-business populists!)

Concern about monopoly is nothing new in this country, of course. Indeed, in the case of petroleum, it was fully justified early in this century before the Standard Oil trust was broken up. But since World War II, despite occasional attention in Congress, interest in the monopoly issue has gradually faded. Why? Simple! Competition keeps breaking out, both domestically and, importantly, from foreign producers.

Well, whom should be blamed for the rise in petroleum prices? The fact that war threatens to engulf the world's major oil exporters would seem to most people to be an adequate explanation. But it's not enough for some who, evidently, need to identify a scapegoat closer to home. Usually it's Big Oil but sometimes it's the local service-station operator.

Is there greed in the plush corporate offices of giant oil companies? Yes, I'm sure there is. How about the grimy repair bays of neighborhood gas stations? Yes, greed is found there, too. Were some petroleum prices raised in advance of cost increases? Yes, surely. Justifiably? Maybe, maybe not. But the issue is really not worth arguing; it's just not all that important. First, greed is not an exclusive characteristic of people in the oil business; it's universal. Why, you will even find it in the halls of Congress and in the hearts of "public-interest" activists — although the goal there may be media attention and power more than money. Greed is as American as apple pie. Second, we shouldn't let ourselves get so worked up about gasoline prices going up sooner or farther than the accompanying costs, because these things almost always sort themselves out before too long. Competition does function the way it's supposed to — not instantaneously, not perfectly, but pretty well.

How do we know? Mostly we know because of the relatively bad performance of alternative approaches, centralized control of the economy and regulated industries. Competitive markets operate more efficiently and produce higher standards of living. We also can tell that competition works by looking at the record of industry profits. Longer term, the rate of return on invested capital averages about the same in all industries. If the oil industry and others are monopolies, where are the monopoly profits?

Years ago, after one of the oil crises of the 1970s had passed, CBS news reporter Harry Reasoner commented on how he was treated when he bought gas, contrasting the period of shortages and controlled prices against the later period of normal competition. He noted that the attendants were again washing windshields, and concluded that, "Competition cleans more windshields." Right you are, Harry!

Ed Fiedler

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

The Middle East crisis, by reminding us how dependent we are for oil from an unstable part of the world, has focused new attention on mandated fuel-efficiency standards for the automobile manufacturers. Considerable support has recently been expressed in Congress for legislation that over the next decade would require each automaker to increase the average fuel economy of its fleet by some 40 percent, to 40 miles per gallon from the present level of about 27 1/2.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

Do you regard this approach — a mandated mileage bill — as a good way to reduce our dependence on imported energy?

Don Conlan
Capital Strategy Research

Why not mandate morality, too! More wrong-end economics. Want to achieve 40 miles per gallon efficiently? Put a sizable tax on gasoline. Regressive? You bet! So is everything else they do down there these days. Maybe add a gas-guzzler tax that really bites. And how about this as a kicker: For every mpg the auto makers must raise the standards, Congress must cut the budget deficit by a no-nonsense $10 billion. Monkey dictate, monkey do!

Charles L. Schultze
The Brookings Institution

The most effective way to prepare for a surge in oil prices is to build up a truly sizable stock pile of crude oil — and be willing to use it. If in addition we want to enforce more energy conservation, then a gasoline tax is a far better way to reduce consumption than mandated mileage standards for auto manufacturers — as is amply documented in a Brookings' study by Robert Crandall and others.

Andrew Brimmer
Brimmer & Company

American automakers should *not* be mandated to increase fleet average fuel economy to 40 miles per gallon. Even with the best engine technology, this would probably require that virtually all new cars be subcompacts. By trading off some pollution abatement equipment to reduce weight, producers probably could stretch average mileage to about 32 miles per gallon. Meanwhile, oil supply should be increased by expanded drilling in a number of offshore and Alaskan areas where it is presently prohibited.

Isabel Sawhill
The Urban Institute

More stringent fuel economy standards are a bad idea. They lead to inefficient decisions by automakers and increase the cost of new cars, causing consumers to drive their old gas-guzzlers longer. A better way to encourage conservation is to increase gasoline taxes. If we had done so a few years ago we wouldn't be in such duck soup now. The deficit, emissions of greenhouse gases, and dependence on foreign oil would all be lower.

Is War Obsolete?

By Carl Kaysen

The forty-five years that have now passed since the end of World War II without interstate war in Europe is the longest such period in its post-medieval history. Many scholars and commentators have attributed the present "long peace" among the major powers to the deterrent effect of nuclear weapons. John Mueller's *Retreat from Doomsday* (New York, Basic Books, 1989) advances a much stronger thesis: major war was already becoming obsolete by the time of the First World War; World War II repeated and reinforced that lesson. The development of nuclear weapons was accordingly irrelevant to the process.

The burden of this essay is that wars of the kind under consideration have become unthinkable because they have become economically and politically unprofitable. Further, Mueller is too cavalier in his dismissal of the significance of nuclear weapons.

> *Wars of the kind under consideration have become unthinkable because they have become economically and politically unprofitable.*

The Historical Background

Understanding why war has become obsolescent requires an examination of the political and economic calculus of war. In the starkest and simplest terms, the key proposition is that for most of human history, societies were so organized that war could be profitable for the victors, in both economic and political terms. But profound changes in economics and politics in the last century and a half, following the Industrial Revolution, have changed the terms of the calculation.

> *In the nineteenth century, economy, polity, society, and culture were all transformed in ways that fundamentally changed the calculus of war.*

For millennia, societies were organized around landholding as the chief basis of both economic and political power. In such societies, successful war yielded a clear gain: control over territory — additional land and the associated labor force — that added directly to both economic and political power. Compared to the potential returns, costs, at least for the winner, were small.

In the political structure characteristic of these societies, the power holders were themselves the warriors, and the connection between those who fought wars and those who, in victory, gained from them was direct and immediate. Conversely, the large mass of the population was separated entirely from political power and almost entirely from war.

This is, of course, a highly schematic account, but as a set of stylized facts, it serves well to characterize most of Europe from the ninth to the fifteenth centuries. By the end of the fifteenth century, the scheme needs enlargement. Nonetheless, over the next three centuries the political, economic, and technical parameters remained such that war could still be seen as an enterprise in which possible gains outweighed costs.

Does War Still Pay? The Economic and Political Calculus

In the nineteenth century, economy, polity, society, and culture were all transformed in ways that fundamentally changed the calculus of war. By the end of the century, urban outweighed rural populations in half of Europe and, by the middle of the next, in most of the rest of Europe and North America, too. War, too, was industrialized: more powerful weapons, larger and more complexly organized armies, and great improvements in supply, transport, and communication changed its scale and intensity. After the American and French Revolutions, the fundamental basis of political legitimacy changed. More and more of the population were included in the politically significant classes.

All of these nineteenth-century changes affected both the potential gains and the potential costs of war. In the economic sphere, land greatly diminished in importance as a resource. Industrialization multiplied both the scale and cost of war; industrial wars involved the whole nation, not the typically small fraction of population and output drawn into earlier wars. World Wars I and II far outweighed anything that had gone before in destructiveness.

On the other side of the ledger, the extent to which the conquest of new territory added to the economic strength of the conqueror is questionable. The question is whether the economy of a different society, all or part of another industrial nation, can be effectively incorporated by conquest against the will of its inhabitants.

Even authoritarian and repressive governments in modern societies need the consent, however tacit and grudging, of the mass of the governed.

In politics, too, the last century-and-a-half has brought a profound transformation. Governments have become popular and populist even when not democratic; the welfare of the general population, conceived in a broad sense, is their chief business, and it is to achieving this that they bend their efforts. And even authoritarian and repressive governments in modern societies need the consent, however tacit and grudging, of the mass of the governed. Economic well-being and social peace are the chief elements on which this consent rests.

Making war can rarely contribute positively to these goals. In the short run, the mass of the public bears heavy costs. Peace, not war, is seen as the natural state of affairs by leaders as well as the public. Further, the dominance of the nation-state as a focus of popular sentiment has delegitimated wars of conquest; they are not only unlikely to be profitable, they are viewed as wrong.

Although the cultural transformation is far from complete, the changes in society, economy, and polity sketched in the preceding paragraphs provide both the context for and a substantial part of the explanation for the obsolescence of major war in the industrialized world.

The argument so far has made no mention of the nuclear revolution, and so far is in accord with Mueller's contention that major war between modern nations was on its way to obsolescence before the development of nuclear weapons. However, this is not to accept that the profound revolution in the technology of war brought by nuclear and thermonuclear weapons and long-range ballistic missiles does not matter; quite the contrary. These new technologies of war have amplified the message of this century's war experiences by many decibels, and set it firmly in the minds of the wide public as well as those of political and military leaders.

Concluding Observations

If wars among modern nations truly serve no possible rational purpose, why is there no wide, even universal, recognition of this proposition? The general answer is that cultures change much more slowly than technologies and institutions. As Keynes said, most living politicians are slaves of some dead scribbler.

For most government and political elites in modern states, the old ideas of military power and "defense" as the core of national sovereignty still carry great weight. Accordingly, providing the capability for war, and being in some sense prepared to use it, still command a large share of the resources and energies of governments.

On a more concrete level, the powerful grip of ideology on governments and publics on both sides of the great postwar East-West divide has diverted attention from the changes sketched above. But the revolutionary change in military technology, especially in the last twenty-five years, has loosened the grip of ideology on both sides of the divide. The self-confessed failure of Communist ideology as a blueprint for successful social organization is helping to complete the process, and opening the way to new thinking in the West as well as the East.

Why is there no wide recognition of this proposition? The general answer is that cultures change much more slowly than technologies and institutions.

Assuming that the foregoing analysis is correct, and assuming further that it can be made widely persuasive, does not imply that the world is on the threshold of universal and perpetual peace. Fully modern industrial nations are still in the minority in the world in both number and population. Civil wars, and forms of violent international conflict falling short of war, are widespread and will continue to be so in the foreseeable future. Nonetheless, this analysis offers a real basis for hope.

These excerpts represent the essence of a much more complex argument published in *International Security,* Spring 1990. Carl Kasen is David W. Skinner Professor of Political Economy at the Massachusetts Institute of Technology.

Power to the People

By Benjamin J. Stein

While stuck in traffic on the Hollywood Freeway a while back, I had a thought:

It is a commonplace of pop-psychosociology to say that modern man has become insignificant. Because of mass production, industrialization, the mystery of science, the bigness of finance, the crowding of cities, and the disappearance of small-town life except as a curiosity, man today is supposed to have become small. This theory of the atomization of man in the industrial context has been memorialized by Karl Marx, Charles Reich, David Riesman and many others. It is a common political theme today, sounded to especially good advantage by Jesse Jackson during the 1988 campaign.

It is true that man can be made to feel insignificant by modern-day industrial society. Anyone who travels through any large city's airport in the summer, or tries to get an explanation of his health insurance coverage, or tries to find out anything about anything from the federal government, well knows the way an atom in a dead leaf in a forgotten field must feel.

But if that feeling is present from time to time, and it is, I respectfully suggest that life confers upon modern man a sense of power unimaginable in earlier eras. Take, for example, the automobile. Anyone who drives a car gets a feeling of power that John D. Rockefeller could only have dreamed of. Yet today it is available to the lowliest licensed sixteen year old.

Or take television: Any entry level clerk-typist can see a color picture, with sound, of creatures fighting in outer space, or the Old West, or live news coverage of a disaster in Dubai or Dallas, or the Cosby household. Not Caesar, not Napoleon, not Lenin or Hitler could wield such control over the fantasy process, which every gas station attendant now takes for granted.

"She shall have music wherever she goes," was once a part of a nursery rhyme invocation for children. The idea that anyone, even a king, could have music wherever he went would have seemed impossible, inconceivable, even for a Hapsburg or a Medici. Today, any child with about ten dollars can own a device that gives him an infinite variety of music wherever he walks or runs, played and replayed as faithfully as if he were in the Kennedy Center. The riches of Alexander the Great could not have begun to purchase such power.

Or, imagine the power of communications in today's world. Only one hundred years ago, when Americans or Hungarians lived in rural areas, their lives were genuinely and unalterably lonely. Read *Winesburg, Ohio* and just try to contemplate such isolation as those farmers and their wives and children put up with day after day.

But today, anyone, of almost any station in life, can pick up the telephone and talk to a friend at any point on the globe, something that was unheard of for the Sun King or for Darius of Persia. Yet any college student thinks it simply a basic part of life. That it exists today is the bestowal of mighty power indeed on those who have it — and that's almost everyone.

Or take travel. Yes, indeed, travel today is crowded, hot, and filled with inconsideration. But one hundred years ago, travel as is commonplace today simply did not exist. Coast-to-coast travel in America was a genuine hardship, a genuine struggle. America-to-Europe travel was lengthy, tiring, and available to only a tiny number of the affluent — except in steerage, which would make today's airline travel look luxurious.

For the ordinary worker to simply pick up and move himself to another continent for about a week's pay would have been inconceivable as a display of power as recently as fifty years ago, perhaps as recently as twenty years ago. Yet that power exists today and is so easily accessed that it would have made Charles Lindbergh's head spin.

Then there is computing power, available to a slightly smaller number, and access to information, also on a scale undreamed of even ten years ago. Anyone can get information from the greatest libraries in the world instantaneously. The merest tot can make calculations in seconds that would have taken the entire Royal Observatory a lifetime.

In a word, the notion that modern *homo sapiens* (although I'm beginning to wonder about the *sapiens* part) is powerless and weak in today's world, that he is an inconsequential nothing, is simply betrayed by facts. To paint modern man as powerless and deracinated is simply to ignore the power that society and that industry have conferred upon Everyman, more power than the Tsar knew existed.

At least it's something to think about when you're stuck in traffic.

Excerpted from *Public Opinion*, September/October 1988, published by the American Enterprise Institute. Benjamin J. Stein is author of *Hollywood Days, Hollywood Nights: Diary of a Mad Screenwriter.*

Industry Outlook Report

October 1990

Overview

Edgar R. Fiedler, The Conference Board

The outlook for most industries closely parallels the general economy: irresolute, trendless, and engulfed in a miasma of lethargy and foreboding. Signs of classic business-cycle downturn are few and far between. But there is foreboding, mostly arising from the Middle East crisis, which has consumers and investors confused, cautious and in the mood to postpone spending plans, perhaps enough to bring on recession.

Our panel of industry analysts confirms this uncertainty. Some, like those in retailing, capital equipment and business-support services, project sales still advancing, although not with any zip. The analysts for chemicals and capital equipment point to international demand as a bright spot, thanks to the strong competitive position afforded U.S. manufacturers by the lower exchange value of the dollar. Sales of cars and trucks are forecast to drop from 14.2 million units this year to 13.8 million in 1991.

The most pessimistic dimension in our industry reports is profits. The exception is apparel where earnings are expected to rise 13 percent this year and 21 percent in 1991. Elsewhere, profits are being squeezed, and dramatically so where oil is a major cost. In chemicals, operating income is expected to fall 25 percent this year and another 15 percent next year, with most of the decline in commodity chemicals. And the airlines are projected to see 1989's $1.4 billion of profits turn into a billion-dollar loss this year, enough to force the disappearance of several weaker carriers.

In sum, the industry outlook is a mixed bag of pluses and minuses. Attitudes, however, show no such balance; they are, rather, overwhelmingly unsettled and joyless. After eight years of fairly steady onward-and-upward performance, it's probably not surprising that the anxieties now outweigh the hopes.

Automobiles

Donald P. Hilty, Chrysler

Car and truck purchases postponed during the early 1980s recovered fully by mid-1989. Then the industry introduced innovative incentives to prop up unit sales. But profits deteriorated as firms began outbidding each other. The best we can expect are sales along their long-term trend: 14.8 million vehicles this year, 15.0 million next.

In the second half of 1989, the industry experienced roller coaster sales. During August and September, especially attractive incentives cleared leftover 1989 vehicles and propelled sales to expected peak annual rates. At 1990 model introduction, price increases and reduced incentives caused annual sales rates to drop to trough levels. This uncharted incentive environment and eroding consumer confidence have made customers, dealers, auto manufacturers, and suppliers skittish. Sales in 1990 have been erratic while averaging 14.4 million (annual rate) or about 2 1/2 percent below the long-term trend.

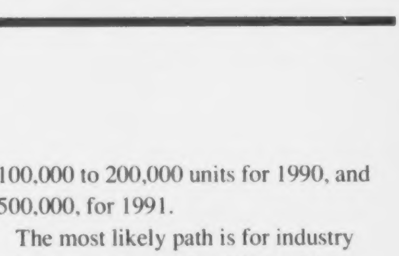
Outlook

August sales fell to a 13.9 million annual rate and probably will not increase for the rest of the year. For next year the industry could find itself on one of 3 sales paths: **(1)** Recovery nearly to trend if the Mideast crisis ends in a few months (25 percent probability), **(2)** Drop to 13.5 million in trough of a recession (60 percent probability), **(3)** Plunge toward 12.2 million if an oil shock occurs (15 percent probability).

During the past month, auto analysts generally have reduced forecasts by 100,000 to 200,000 units for 1990, and 500,000, for 1991.

The most likely path is for industry sales to average 14.2 million vehicles this year, 13.8 next. July inventories seemed healthy: 68 days supply versus normal 62. End of August stocks climbed to 70 days supply versus a normal 59.

Thus auto profits will be meager this year and next: near break-even from North American operations (slim for cars, better for trucks) and down somewhat from international operations.



Chemicals

A. Nicholas Filippello, Monsanto

As the economy flirts with recession and the impact of events in the Middle East begins to be felt, the U.S. chemical industry faces a challenging environment. Domestic demand is likely to parallel volumes in key end-use markets.

Any economic downturn will have a direct and immediate effect on demand from cyclical industries such as automotive vehicles, construction and consumer durable goods. Demand from less cyclical end-use markets, such as pharmaceuticals, food, soaps and personal products, should maintain some growth.

International demand will continue strong because of expected growth in Far Eastern and European markets, a weakened dollar and a U.S. comparative advantage in high value chemical products. The industry should continue to be among the best international trade performers with an annual trade surplus of $12-15 billion this year and next.

In recent months there have been selected increases in the prices of basic petrochemicals, owing to refinery accidents, weather damage and, more recently, to uncertainties in world petroleum markets. Nevertheless, there still exists a worldwide surplus of petrochemical production capacity. Planned capacity build-ups for commodity petrochemicals and plastics, particularly in Asia, will widen this gap over the next three years. Ultimately, economic forces will reassert a sustained decline in real petrochemical prices.

In the face of higher feedstock costs, commodity chemical profit margins will remain under pressure as excess capacity limits the degree to which costs can be passed on. Recent oil price increases will thus be felt more by producers of basic petrochemicals than by producers of downstream value-added products.

Additionally, in an economic downturn, specialty chemical producers would be affected less than commodity producers. Demand and pricing for specialty products are determined more by value created for downstream customers than by input costs or near-term supply-demand balances.

Longer term, the restructurings of major chemical companies during the 1980s will serve the industry well. The challenge still exists, however, to control costs, enhance productivity, reduce toxic emissions in a cost-effective manner, refine product portfolios and invent and develop the growth products of the 21st century for the world market.

Industry Sales & Profits

	1989	1990*e*	1991*e*
Sales	+7.5%	+2.5%	+1.0%
Oper. Inc.	-5.3%	-25.0%	-15.0%

Business Services

Joseph W. Duncan, Dun & Bradstreet

In the 1970's corporations attempted to organize, through vertical integration, all business services under their direct control. In the 1980's, with increasing cost pressure and more specified strategic focus, business services were moved outside the organization and into the services sector. Now as the 1990's start, business services are increasingly focused on providing highly productive, relevant input to their clients in other sectors.

Since government statistics have failed to evolve as quickly as the sector of business services has evolved, not much data are available for this part of the economy. Employment data can be used as one indicator, however. In 1989, the business-services sector (defined by BLS) employed 5.8 million workers or 5.3 percent of the labor force, up from 3.4 percent in 1980, before the divestiture of these activities from larger corporations.

Business services is a very diverse sector. It can be divided into two broad categories: (1) business support, which includes advertising, credit-reporting, and computer and data-processing services and (2) infrastructure support, which includes mailing and reproduction services, temporary help and maintenance and custodial services to buildings. Infrastructure is about twice as large as the business-support segments.

This distinction is important. Employment growth in infrastructure services is highly cyclical and currently in the midst of a downturn that began in 1989. In contrast, employment in business-support services continues to be strong. While this sector is not immune to the business cycle, a case can be made that these essential functions increase in importance during times of economic stress, since they may increase productivity or revenues. For example, as business failures increase (they are currently up 12 percent over year-ago levels) credit ratings become increasingly important to companies who want to be certain that their bills will indeed be paid.

In conclusion, the business services sector is demonstrating some stress as the economy is slowing. However, some business services are essential, particularly in times of economic stress.

General Merchandise Retailing

Thomas Swanstrom, Sears, Roebuck

In an uncertain forecasting environment, we believe that general merchandise sales growth in 1991 will look a lot like 1990. Our forecast calls for a 4.6 percent gain in dollars, which would only be slightly lower than the 4.7 percent increase estimated for 1990. But the gain next year will consist of a little more inflation and less real growth than will be true for 1990. We expect general merchandise inflation to rise from a 2.7 percent rate in 1990 to 3.2 percent in 1991. Real growth thus would slip from 2.0 percent in 1990 to 1.4 percent in 1991.

In terms of merchandise categories, the best gains should be registered by computers and business equipment, paint and wallcoverings, women's apparel, lawn and garden supplies, floorcoverings, and children's apparel. Women's and children's apparel sales in particular are very resistant to a slow economy and both should do well. When apparel spending cutbacks are made, they normally appear first in the men's clothing area and rarely impede women's apparel sales.

Luggage, sporting goods, small appliances, furniture, hardware, and auto accessories are forecast to be relatively weak spending areas.

By region, the greatest weakness should again be felt in the Northeast with the Massachusetts, Connecticut, and New York markets being the most impacted. Pockets of regional strength should include Houston, Seattle, Puerto Rico, Portland (Oregon), Las Vegas and Northern California.

Retailers have been very conservative in buying for the Christmas season, often drastically shortening their ordering lead times. Industry inventories are thus now in very good shape. But, if Christmas business turns out to be better than expected, this posture could result in some last-minute scurrying to fill the merchandise pipelines.

Apparel

Edward F. Johnson, Prescott, Ball & Turben

Apparel manufacturers have faced an uphill battle over the years to increase sales and earnings and even to stay alive. Their biggest adversary has been imports, which have increased share of the consumer market to 42 percent for 1989 from 17 percent for 1973. Last year, imports were up 14 percent compared to a 4.7 percent increase (adjusted for inflation)in consumer expenditures on apparel. On top of this gradual erosion of the market for domestically manufactured apparel, there are periodic downswings in retail buyer demand for product due to excess inventories at retail stores. The ongoing consolidation of stores into larger companies has made for fewer individual retail companies and the necessity for larger apparel companies to supply their requirements. The recent bankruptcies and near bankruptcies of Ames, Allied, Federated, Macy, etc. have added another note of uncertainty for apparel managements.

These negatives have resulted through the years in the disappearance of such well-known companies as Bobbie Brooks, Kayser Roth, Villager, Jonathan Logan, etc. Also the recent merger and buy-out craze has resulted in the disappearance from the public market of such as Hanes, Cluett Peabody, Champion Products, Levi Strauss, etc. But all is not gloom and doom. Apparel companies are sourcing more products from the Caribbean, Pacific Basin, and other foreign countries. The current trend to "just in time" retail ordering to reduce inventory levels has favored domestic producers over long-lead-time imports. A number of companies are also fighting back by rapidly establishing dual distribution through chains of factory outlet stores.

The apparel industry has recently been on a roller coaster, however. The industry recession of 1987-1988 caused by high women's wear inflation (consumer prices for women's wear increased 6.2 percent in 1987), high retail inventories, and fashion confusion was replaced by a short industry upturn starting in the fall of 1988. This upturn came to a halt around September 1989 as high retail inventories (partly caused by overordering of private label imports) sharply reduced store buying. This downturn was made worse during the first seven months of 1990 by high women's wear inflation, again resulting in consumer spending on women's wear to be up a low 0.8 percent, compared to an increase of 5.1 percent for all of 1989. Retail ordering became more cautious following the Iraqi crisis with consumer spending on general merchandising slowing down starting in the third week of August.

But this poor environment is expected to be followed by an upturn in 1991. The Redbook index of apparel company earnings projects gains of 13 percent for 1990 and 21 percent for 1991, following a 17 percent increase for 1989.

Airlines

George W. James, Airline Economics, Inc.

The deregulated U.S. airline industry continues to move toward its instinctive objective: a few large carriers holding immense domestic and international route systems. Meanwhile, however, the several airlines destined to leave the system, e.g., Eastern, Pan Am and TWA, warp the normal pricing and profitability patterns as they make cash flow their top objective. More significantly, the Iraqi action in the Middle East has placed a potential fuel cost burden on the airline industry that not only alters the financial outlook from nominal profitability to possible record losses but also accelerates the demise of the several marginal carriers.

Airline Financial Performance

	1988	1989	1990
Revenues	+12%	+7%	+7%
Costs	+10%	+10%	+10%
Profit/Loss	$2.8 bil.	$1.4 bil	($1 bil)

From 1983 to 1988 airline profitability improved as mergers, acquisitions and bankruptcies occurred across the system. Those carriers with growing hub-spoke systems, computerized reservation systems, sophisticated pricing mechanisms, and expanding international route structures, crowded out other carriers and their profitability improved. Then the competition among the remaining nine large carriers intensified as the weaker ones struggling for survival resorted to severe price cutting for cash-flow purposes. Linked with a stagnant U.S. economy, this began a 1988 profitability decline that has continued into 1990.

Accelerating this adverse impact on the industry is the Iraqi fuel crisis which, with a possible crude oil price increase of $7/bbl. from $18 to $25, will raise U.S. airline jet fuel costs by $4 billion annually. A $1/bbl. increase in crude raises jet fuel 3-1/2c per gallon. Every 1c increase in jet fuel increases costs by $160 million.

With these cost increases ahead, the industry now must reverse its 1990 operating profit outlook from about $500 million to a possible record operating loss of $1 billion. That will force the disappearance of the more marginal carriers and, in the face of a flat economy and rising fuel costs, offer the possibility that 1991 will still show operating losses.

Then, beyond 1991, industry profitability will improve significantly as the remaining carriers, highly efficient and not faced with "fire sale" pricing, allow the industry to approach normal U.S. industry profit margins.

Capital Equipment

Adrian T. Dillon, Eaton Corporation

Short run, the major impact of the Persian Gulf crisis will be the heightened sense of uncertainty about the future that will make us postpone discretionary, big-ticket purchases like cars, homes, and "short-cycle" capital goods. That hesitation will, at a minimum, prolong the sluggishness in economic activity through year-end. But, unless the situation in the Middle East deteriorates sharply from here, we do not believe a U.S. recession is "inevitable:" The net impact of higher oil prices will be to delay – and dampen – the rebound in growth that we had expected during the second half of this year.

In view of this prolonged economic slowdown and the continuing pressure on operating profit margins, the stability of capital equipment spending to date is itself remarkable. The July-August capital spending survey, with its 5-percent inflation-adjusted rise in 1990 spending, illustrates the sustained commitment by U.S. businesses to reinforce their competitive positions for the brutal global competition of the 1990s. Among the major components, the strength this year has been in aircraft and information-processing equipment; trucks and industrial equipment have shown the most weakness.

A 5-percent increase in 1991 equipment spending is not as aggressive a forecast as it may seem to be. Information processing growth is expected to slow to less than 6-percent, the slowest pace in over a decade! Motor vehicle purchases, after a two year decline, are expected to rise modestly while higher aircraft deliveries will continue to boost total transportation-equipment purchases. Industrial-machinery purchases are expected to be up less than 2-percent. Thus, other than aircraft, there's no large area of strength; rather, it's the absence of new areas of weakness that in effect give a boost to overall spending. Assuming the overall economy grows 2-percent to 3-percent in 1992, equipment purchases should show more uniform strength, with total purchases up about 6-percent. Finally, with the dollar reaching new lows, the outlook for U.S. trade in capital goods keeps improving. U.S. capital-equipment producers should, therefore, do better than implied by the increase in domestic demand.

Quotable Quotes

Thomas Sowell on Politics

My political bias is that I'm biased against politics. I haven't been a member of any political party since 1972. And I am really quite disenchanted with politics of all sorts.

Why? Mainly just by following what they do and how they do it. They're really quite clever at the things they do, but the things they do really don't benefit the public very much.

If that's changed any over the years, it's been for the worse. But I see some hopeful signs: People are talking about limiting the terms of Congressmen. I would like to see them limited to one term. If, for example, you're going to allow a Representative to spend four years in the House, I would rather see that changed to one four-year term rather than two two-year terms, because the problem is re-election. As long as they have to be re-elected and have to raise all that money, then they're going to sell out the public interest to get the money. It's really quite simple.

For example, an industry like the sugar industry can contribute money to Congress and Congress will appropriate enough subsidies to the sugar industry to pay them back a thousand dollars on every dollar. There aren't many places you can get that kind of return on your investment. There is no sign that's going to stop--either that the industry is going to stop offering the money or that Congress is going to stop giving the subsidies.

And on Intellectuals

I'm thinking of writing a book about intellectuals. Yes, Paul Johnson just wrote one, but mine would not be as generous as his.

How should we define "intellectual"? I think of it as an occupational description. They're people who make their living with words. There's nothing qualitative about it. I will not assume, for example, that the average sociologist is smarter than the average auto repair man. So it's not an honorific term, it's simply a job description — the way you would describe an accountant or a policeman or any other job.

It's not that I don't like intellectuals; in fact I think they're funny in some ways. But intellectuals have a set of attitudes and beliefs that simply will not stand up under scrutiny, and which have been enormously damaging to society. Now if it was merely that they had a few crazy ideas of their own, which they kept among themselves, who would care? But many of these ideas — preferential policies, for example, and environmentalism — have sacrificed an enormous volume of resources, and thus reduced the well-being of other members of society. And all of that has been done just so a handful of people can feel especially noble and especially wise.

(Dr. Sowell, a Senior Fellow at the Hoover Institution, Stanford University, is the author of *Preferential Policies, An International Perspective*. The above is adapted from his remarks on "Booknotes," a C-SPAN television production recorded May 24, 1990.)

Deja Vu All Over Again

The defense industry boom is fading. After a full decade of rising military outlays, the Pentagon has started to slash procurement as well as hold the line on its research and development outlays…Warnings about the impact of defense procurement cutbacks have come in loud and strong from government officials and from witnesses before Congressional subcommittees…[A] Deputy Assistant Defense Secretary…chided defense contractors for not moving vigorously in planning for adjustment. He accused some of wistfully clinging to the status quo and told them there's good evidence that others are suffering from "hardening of the management arteries."

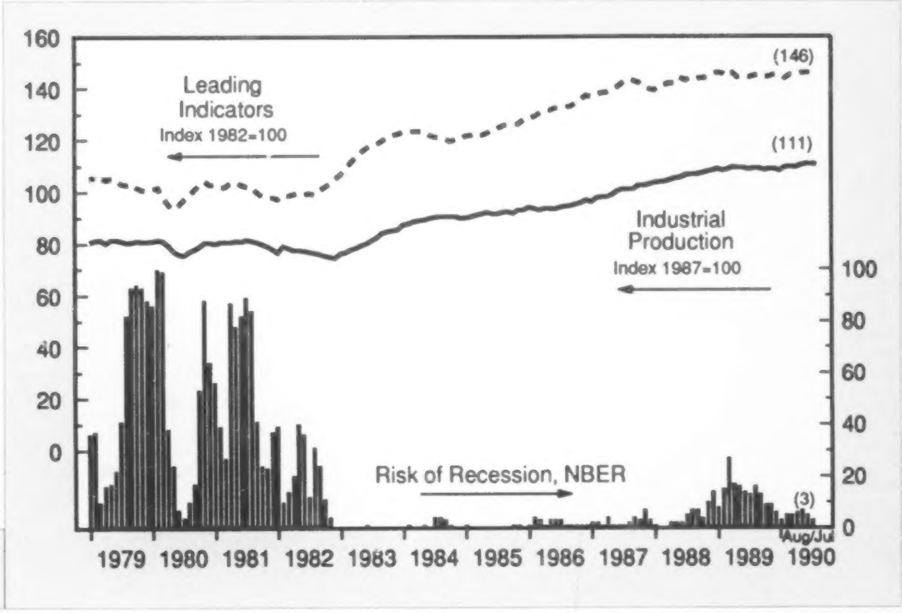
Where…can defense contractors turn?…Areas frequently mentioned that could benefit from application of defense technology include advanced urban mass transit systems, improved air and space travel, improved communications and weather forecasting, and more reliable air and highway traffic control systems.

Excerpted from *Business Week*, July 18, 1964.

Conference Board Stat File

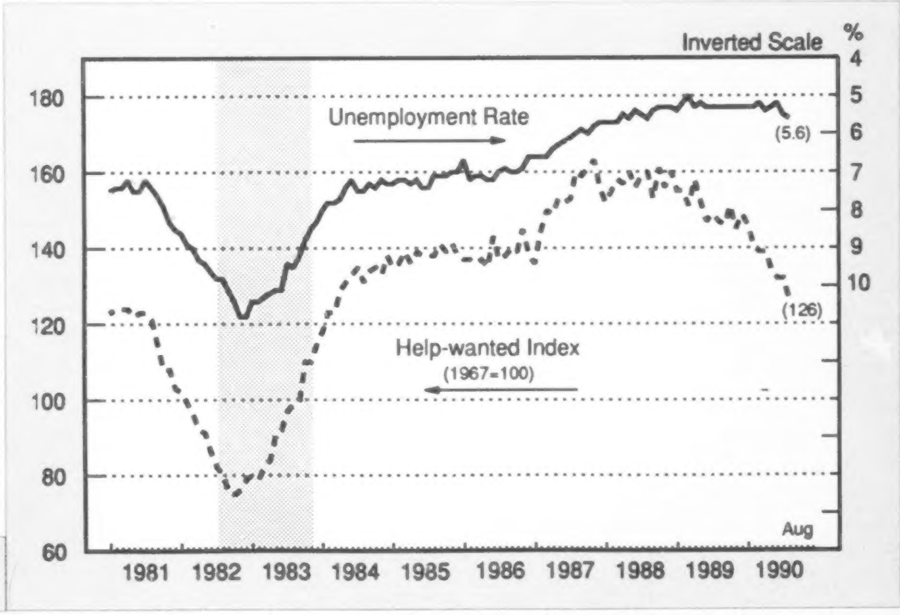
The data in our Stat File provide confirmation that the economy is sluggish, but are inconclusive on the widely heard idea that a recession lies immediately ahead. Two series do point that way, consumer expectations and help-wanted advertising. But others do not, including the leading indicators, the diffusion indexes, and especially the NBER risk-of-recession calculation. In our view, however, the chances of recesssion have increased to something close to even money, but our quess is that economic activity will bump along indecisively without quite falling into a cyclical downswing. Whatever happens, the economy seems sure to be soft enough that the media will be talking recession for some time ahead. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Flat economy. Recession risk low.

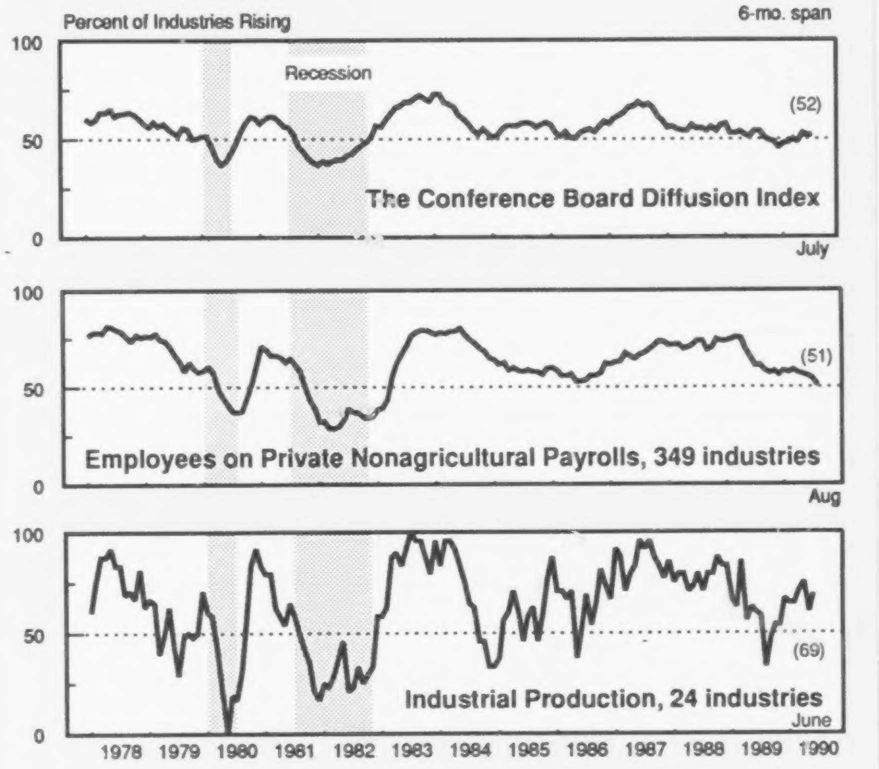
Help-wanted Advertising and Unemployment



Labor demand falling.

Conference Board Stat File

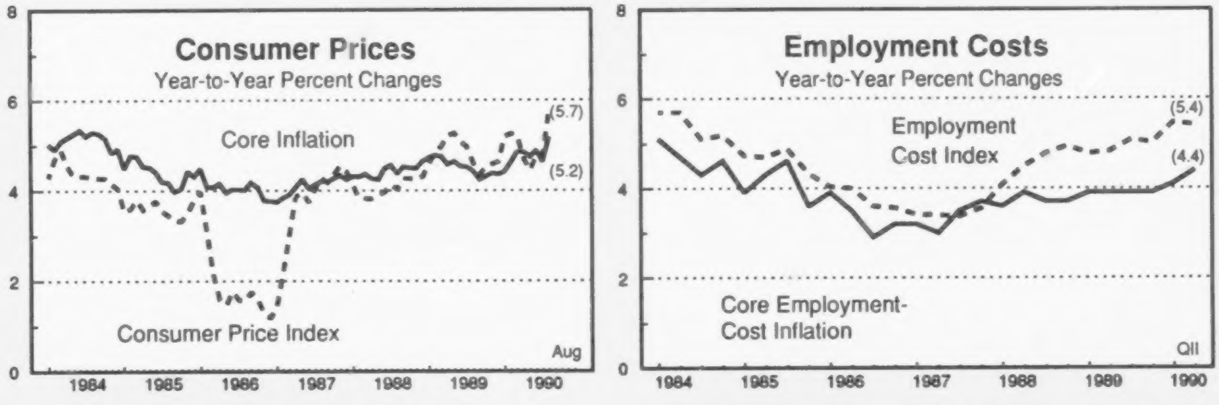
Indexes of Economic Momentum



Momentum indicators in neutral.

Both prices and wages showing acceleration.

Inflation Fundamentals



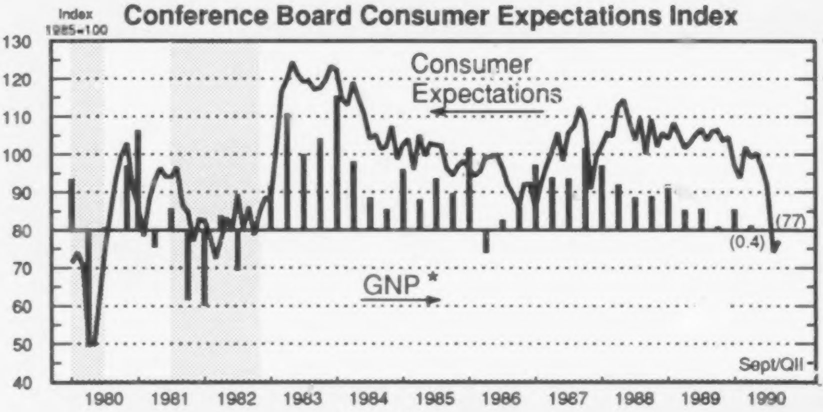
Core inflation = CPI excluding food at home and energy

Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

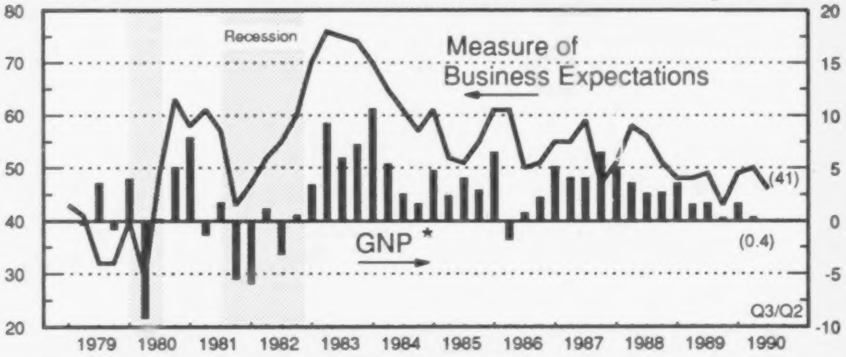
Conference Board Stat File

Confidence

Conference Board Consumer Expectations Index



Conference Board Measure of Business Executives' Expectations

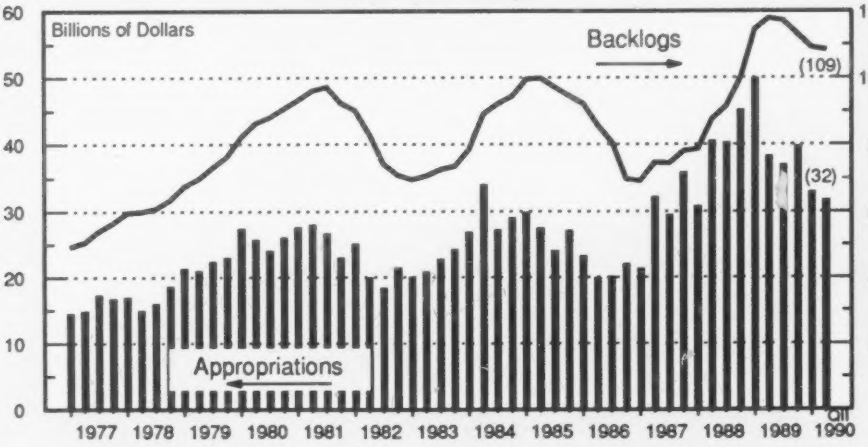


* Quarterly percent changes in GNP at annual rates

Consumer confidence shaken.

Investment Intentions

Conference Board Capital Appropriations
Manufacturing



Manufacturers' expansion plans losing energy.

Inside the Crystal Ball

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Aug	Sept.		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%	%	%	%	%		
Actual	1990 1Q	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1Q 1990	Actual
	2Q	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	2Q	
Forecast	3Q	0.4	0.8	1.3	0.3	1.6	1.4	0.2	0.7	3Q	Forecast
	4Q	-2.4	0.2	0.0	-1.5	1.1	-2.1	-0.1	-0.8	4Q	
	1991 1Q	-3.2	0.7	-0.5	-0.5	2.0	-1.5	1.0	0.8	1Q 1991	
	2Q	1.8	1.5	0.6	-0.7	1.5	0.5	1.8	1.4	2Q	
	3Q	7.4	2.5	1.1	0.8	1.8	2.0	2.9	1.6	3Q	
	4Q	6.0	2.6	1.6	3.0	2.0	3.1	2.0	1.6	4Q	
	1992 1Q	3.8		4.0		3.5	2.7	2.6	2.3	1Q 1992	
	2Q	2.7		4.0		2.5	3.0	2.5	2.0	2Q	
	3Q									3Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	1989 4Q	Actual
Forecast	1990 4Q	4.4	5.1	4.9	5.4	4.9	4.9	3.9	4.4	1990 4Q	Forecast
	1991 4Q	3.8	4.1	4.4	3.9	4.8	3.7	4.2	4.3	1991 4Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DUPONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1990 1Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	1Q 1990	Actual
	2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q	
Forecast	3Q	5.6	5.5	5.5	5.6	5.6	5.5	5.6	5.5	3Q	Forecast
	4Q	6.1	5.8	5.7	5.9	5.6	5.9	5.9	5.9	4Q	
	1991 1Q	6.8	6.0	5.9	6.0	5.8	6.3	6.1	6.2	1Q 1991	
	2Q	7.1	6.1	6.0	6.3	5.8	6.5	6.2	6.3	2Q	
	3Q	6.9	6.0	6.0	6.4	5.8	6.7	6.2	6.3	3Q	
	4Q	6.5	5.9	6.0	6.0	5.8	6.7	6.2	6.3	4Q	
	1992 1Q	6.2		5.9		5.6	6.7	6.1	6.3	1Q 1992	
	2Q	6.0		5.8		5.5	6.6	6.1	6.3	2Q	
	3Q	5.8		5.7		5.5			6.2	3Q	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
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additional mailing offices

P41c5-80

The Conference Board

Volume 1, Number 6
November / December 1990

Economic Times

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- **The Crystal Ball** *(page 11)*

Editor's Note:

Our main focus this month is the great budget buffoonery of 1990. This includes reactions from our Colloquium panel on the next page, a lively collection of quotes, etc., on pages 6 and 7, and even the wisecrack of the month at the bottom of this column. In addition, Henry Aaron's (no, not the baseball hero!) ideas about the economic policy needs of the country, longer run, put a good bit of emphasis on the budget, too. Finally, we get some insightful good news from Ben Wattenberg on page 8.

Ed Fiedler

Maxim of the month:

The four fundamental principles of American finance —

- **we want everything,**
- **we want it now,**
- **we want it for free,**
- **and if we discover that it isn't free we want someone else to pay for it.**

Mark Halprin, *Wall Street Journal*, October 23, 1990

How Bad?

Now that Washington has finished (for now) with the budget, the central economic question is recession, yes or no. At the moment it's still a close call, with almost as many statistical series saying no recession — most important, consumer spending, including automobiles, which, as a big ticket item, should be especially vulnerable in the present environment — as there are series with behavior that is consistent with recession. The guess here (this week!) is recession, but we'll have to wait and see.

In the end, however, this issue deserves less attention than it's been getting. Recession or no recession, the economy is in for a period of considerable weakness. It will be, as Al Sommers puts it, a long, tough workout.

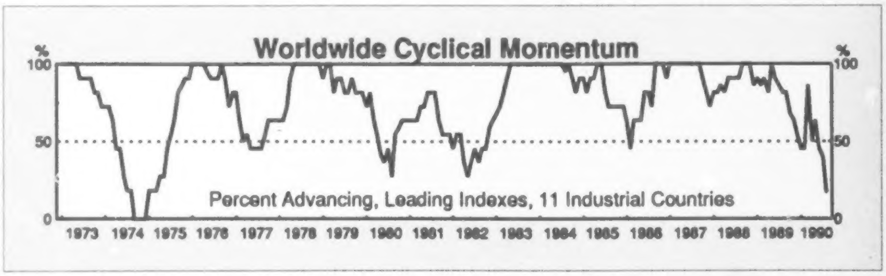
The more important question is: How much weakness and for how long? And subsequently, how vigorous a recovery? Here, again, there are good arguments on both sides. It is, for example, difficult to be pessimistic when the inventory overhang in the economy is minimal. Yes, inventories will decline, as always. But how much additional weakness will the economy experience because inventories have been overbuilt? At present all signs say very little.

Similarly, it is difficult to be pessimistic when profit margins seem to be holding up pretty well. Further, it is difficult to be pessimistic with the low dollar making U.S. producers highly competitive in world markets.

On the other side, we find that the cyclical weakness is global in scope, as shown in Geof Moore's chart below. As he has observed, one factor that distinguishes serious recessions from mere slowdowns is that serious recessions are international in scope. More worrisome is the troubled U.S. financial system, which could easily postpone or retard an economic recovery.

Thus it is not at all clear how long and difficult a spell the economy will have to live through. If this does prove to be a recession we're in now, my guess would be that in the end its dimensions will resemble the eight recessions since World War II. As a rough rule of thumb, this would involve an economic contraction lasting between six and sixteen months, a 1 to 5 percent decline in real GNP, and unemployment climbing to between 7 1/2 and 9 1/2 percent. Within that range, my bet is for a shallow decline and a subdued recovery.

This approach does not make for precise forecasts. Nevertheless, the history tells us two useful things: First, although recessions are not all alike, there is something of a family resemblance among them. Second, for the economy as a whole, the distress created by a recession is harsh but not unbearable. It will leave few if any pleasant memories, but we will survive it.



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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
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Colloquium

Background:

The recently completed budget bill is highly controversial, among economists as well as politicians. Some don't want to reduce the deficit. Some like the idea of cutting the deficit just fine, but not how it's being done. Some think there's still a lot of blue smoke and mirrors in the promised cuts. And others think, all things considered, that it's a highly satisfactory compromise.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

How comfortable are you with this budget legislation? Will it achieve its five-year $500 billion goal? Will it help the economy?

John T. Dunlop
Harvard University

Comfort is not an estate known to economists. The budget legislation is all we've got; it is better than the indefinite continuation of impasse. But it is not great. Much depends on the reactions of the financial markets and the Fed which should reward the effort liberally in this recessionary climate. Longer term the spending-control provisions that the bill gives to the President to deal with legislated excesses in broad categories may be more significant.

Albert M. Wojnilower
First Boston Corporation

The new budget properly leaves the probable deficits for 1991 and 1992 (excluding deposit-insurance costs) about where they've already been for four years. Higher taxes on the rich and for Medicare are appropriate, but the higher sales taxes will be more trouble collecting (and to the cost of living) than they are worth. With many financial institutions in desperate straits, counting on private credit growth to countervail a reduced budget deficit would have been suicidal.

Stephen H. Axilrod
Nikko Securities International

I'm fairly comfortable with the legislation. It begins to address the nation's structural savings deficiency and ends the Gramm-Rudman farces, but more will need to be done. Private savings rates remain disappointingly low, and the budgetary savings will certainly not be as large as currently promised. From a cyclical perspective, the package comes several years late, with the effect that the Fed is left with the full burden of stimulating economic recovery before it can be sure inflation is under control.

Charls E. Walker
Charls E. Walker Associates, Inc.

The budget agreement fails to confront the American voter's preference for low taxes and high government spending that is the fundamental fiscal problem in our increasingly plebiscite democracy. The agreement should have more strongly curtailed entitlement growth, vastly improved the President's powers to restrain a spending-prone Congress, and supplemented our highly unpopular income and payroll taxes (which now provide 90 percent of Federal revenues) with a "less unpopular" revenue-potent VAT.

U.S. Economic Policies for the Nineties

By Henry J. Aaron

The last decade of the American century has begun. The United States that emerged from World War II produced nearly half of world output and enjoyed uncontested military superiority because of its monopoly of nuclear weapons. It helped restore the economies of Western European countries devastated by war. It nurtured multilateral free trade to the benefit of all. It rearmed to neutralize military threats in Asia and Europe. For four decades the United States stood as the bulwark of the NATO alliance. And as the decade of the nineties begins, that military and diplomatic resolve has been rewarded by political and economic reform in once-hostile tyrannies around the world.

At home, World War II called forth the highest output that this or any other nation had seen. Three subsequent decades of rapid growth surpassed even that achievement. Until the 1970s, inequality fell as incomes rose. The long struggle for simple justice overthrew legal barriers to equal participation in American life by minorities, most notably African-Americans.

> *The proud achievements of the preceding four decades cannot obscure a growing sense that the United States is faltering.*

But as this new decade begins, the proud achievements of the preceding four decades cannot obscure a growing sense that the United States is faltering. The United States is paralyzed by a psychosis of poverty and helplessness in the face of problems at home and abroad. Possessor of the largest and deepest capital stock in the world, its saving rate is lower than that of any other developed country and less than half its own rate during the first three postwar decades. Beneficiary for decades of a system of free trade, it now quails before economic competition and flirts with proposals to undermine free international markets. World pioneer of mass public education, its students now perform worse than those of virtually all other countries for which data are available. Underwriter of the world's most costly health care system, it leaves more than 31 million people uninsured and millions more inadequately covered or at risk of losing coverage. Richer than ever before, it has found no way to reduce the significant fraction of its population that is poor, a fraction that remains larger than that of other industrial nations with lower average incomes. Victor in the cold war, its response to pleas from the countries of Central America and Eastern Europe for help in rebuilding economies ravaged by central planners is to agonize over how to shift monies within an already shrunken foreign aid budget.

President Bush stated in his first inaugural address, "We have more will than wallet." But the United States is a nation blessed with the highest per capita income of any developed country in the world. Its national product is two and a half times larger than that of the second largest economy. It is enjoying its longest peacetime expansion. The question is not whether America has enough wallet, but whether it has the will to use its abundant wealth to solve the problems that it faces.

> *The United States faces nagging problems whose solutions require immediate and tangible sacrifice but offer deferred and diffuse benefits. From such burdens leaders in the White House and Congress can easily shrink.*

The United States faces no imminent crises that demand decisive leadership. It confronts neither lethal threat from abroad nor economic crisis at home. Rather it faces nagging problems whose solutions require immediate and tangible sacrifice but offer deferred and diffuse benefits. From such burdens leaders in the White House and Congress can easily shrink. The nation can muddle through without absolute decline. Yet Americans cannot escape the reality that decisions taken during this decade will determine whether the chronicle of growth at home and influence abroad continues or flags.

Each January since the early 1980s Congress has convened under the shadow of large and damaging deficits. Late in the month presidents have transmitted to Congress budgets typically based on overly optimistic economic assumptions. All have called for large cuts in domestic expenditures. Most have called for a few small tax increases, usually camouflaged. Most have used such ploys as asset sales to hide the deficit's true size. In the months that follow, members of Congress find they cannot agree on honest expenditure cuts or tax increases that will meet the official deficit reduction targets. And so they fashion, sometimes alone and sometimes with the aid of the administration, quaint and curious budgetary evasions. In the end, Congress adjourns after certifying compliance with the deficit reduction targets, when in fact little or no progress has been made.

The United States is avoiding national priorities rather than setting them, jeopardizing future success at home and abroad — economically, socially, diplomatically, and militarily. Earnings per worker have not grown for more than fifteen years, and the distribution of income has become markedly less equal. Growth of productivity is depressed. American businesses are losing competitive ground abroad. In the age of media hype, everyone has become jaded by exaggeration. But it is no exaggeration to say that what is done about national saving, investment, research, education, and health will determine whether America chooses excellence or mediocrity.

The overriding message can be simply stated. The United States remains rich and strong. Its richness and strength reflect an inheritance from nature and from past generations of Americans: a temperate climate, abundant resources, public institutions supportive of growth, and most of all an environment that rewards hard work, skills and innovation. These are not immutable gifts. The United States can sustain and build upon its inheritance, but only if it cuts short its national consumption binge, spends its wealth sensibly, and responds with imagination to the opportunities and challenges that are emerging at home and abroad.

Three themes echo loudly: One is that important progress can be made on some of America's problems — education, transportation, and the global environment — without spending large additional sums if the nation is willing to reform several current policies. Highway and airport congestion, for example, can be improved by changes in usage fees and by changing the way these facilities are built.

While the deficit has lost its capacity to shock, it has not lost its power to damage the economy by diverting roughly half of private saving from productive investments at home or abroad.

Second, traditional modes of addressing certain national problems must give way to new ones. In education, for example, without fundamental changes in the way schools are managed and in the criteria on which they are judged, more money is almost sure to be spent to little effect. And in international commerce, although free trade still promises enormous benefits, government intervention — to support research, to facilitate cooperation among domestic companies, or to penalize the anticompetitive behavior of other countries —may be required to sustain free trade.

Third — and perhaps the theme that echoes loudest of all — the fiscal mismanagement of the United States must end. Until the President and Congress take the necessary actions, progress on many national priorities will be hamstrung.

That the government finances of the United States are being mismanaged is not exactly breaking news. The federal deficit has been around long enough to seem normal — and boring. While the deficit has lost its capacity to shock, it has not lost its power to damage the economy by diverting roughly half of private saving from productive investments at home or abroad. Had the federal deficit risen because of a sharp increase in public investment, it would pose much less of a problem. In fact, net investment by the government has fallen. If private saving had risen, increased federal borrowing might have been harmless; however, net private saving in the 1980s fell to less than half the rate of the preceding three decades. The United States is in the midst of an extended consumption binge. Current national saving barely exceeds the annual depreciation of the existing stock of capital goods. Depressed saving slows growth of worker productivity. It is conventional wisdom that because of the deficit the United States cannot afford to solve serious problems of health care, education, and infrastructure. In fact, failure to attack these problems and the deficit simultaneously stems from a deeper common source: American leaders have been unwilling or unable to try to persuade the people of the need to cut spending, to raise taxes, or to take other controversial actions.

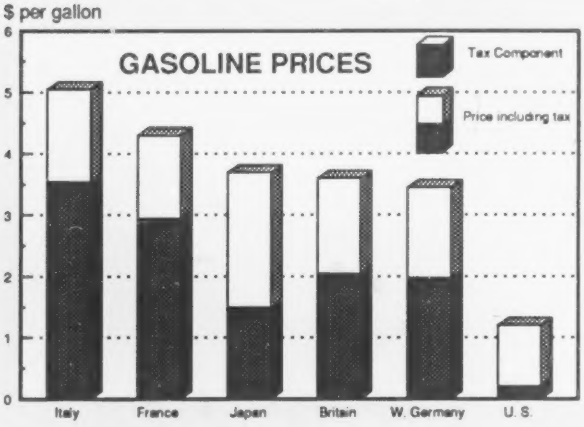
America's problems threaten no crises. They are hard for a democracy to solve, for they require that its citizens, most of whom are prosperous, make current sacrifices for long-term gains. They require that people unaccustomed to failure forsake old ways of thinking for new ones. The task of mobilizing the American people to deal with such problems and persuading them to do what needs to be done calls for both skill and courage.

Excerpted from *Setting National Priorities — Policies for the Nineties*, Henry J. Aaron, Editor, 1990, The Brookings Institution, Washington, D.C.

Perspectives On

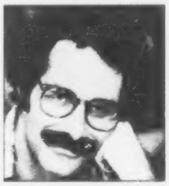
The budget problem begins with the people. Congress is relatively representative of the people and the answer Congress typically hears, when it asks what programs should be cut, is foreign aid, welfare and your salary. Congress panders to the popular notion that although deficits are a bad thing they are always the fault of somebody else — a welfare mother, a militarist, a road builder, etc. Because the public does not insist its representatives attack the deficit in a systematic way, it is easier for Congress to continue responding to constituency groups interested in particular programs, groups whose support at election time is always more important than those with a generalized concern about unbalanced budgets.

Retiring Minnesota Congressman **Bill Frenzel**, September 18, 1990.



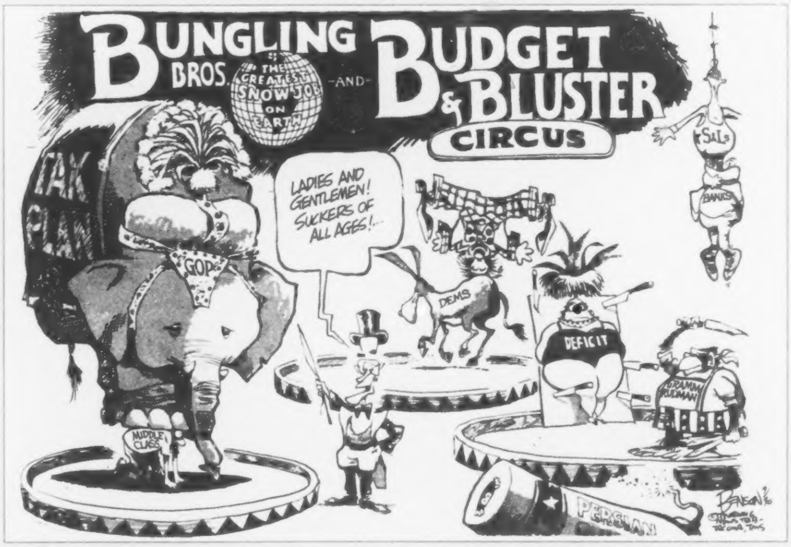
Source: American Petroleum Institute

Other countries must find our fussing about a nickel a gallon highly amusing!



Not one discretionary domestic program was eliminated — not Amtrak, not the Small Business Administration, not art subsidies. *Not one.* Everything is apparently essential.

Robert J. Samuelson, *Newsweek*, October 15, 1990.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THE GREATEST SNOW JOB ON EARTH
-AND-
BUDGET & BLUSTER
CIRCUS
TAX PLAN
GOP
LADIES AND GENTLEMEN! SUCKERS OF ALL AGES!...
DEMS
DEFICIT
GRAMM RUDMAN
MIDDLE CLASS
S&Ls
BANKS
PERSIAN
BENSON

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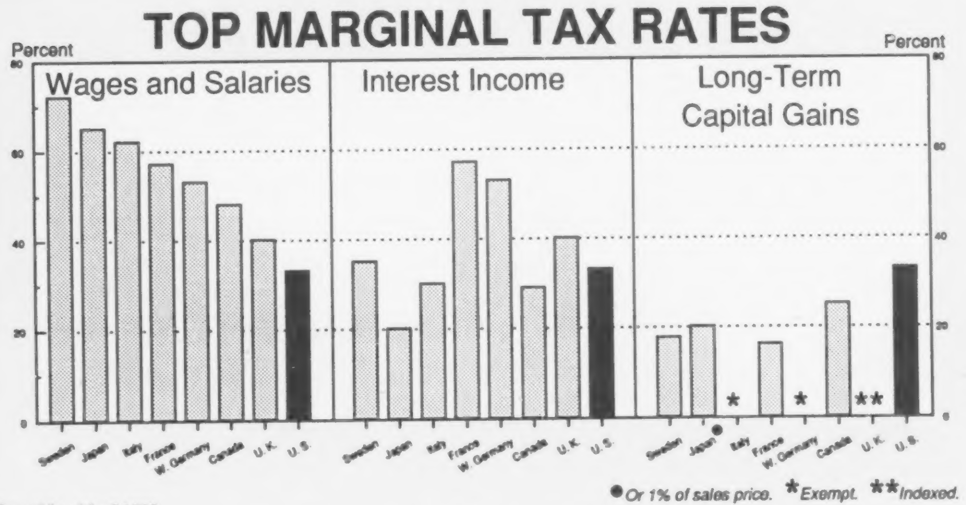
The Budget Brouhaha



As of April 1990.
Compiled by American Council for Capital Formation Center for Policy Research.

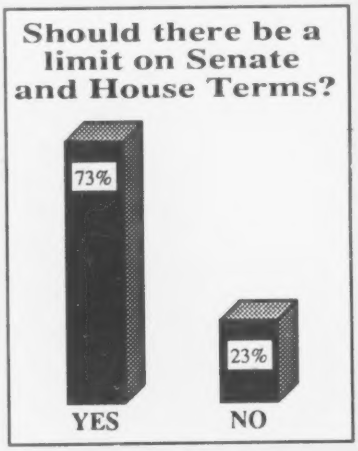
Until the recent change, the U.S. was the only country to apply the same top tax rate to wages and salaries, interest income, and capital gains. That helps to constrain the tax-shelter business, but it also misses the opportunity to offer a little extra incentive for saving and investment that other countries provide.

Over time, the top marginal income tax rate in the United States has come down significantly from 91 percent in the 1950s…it was reduced to 70 percent by the 1964 tax cut…to 50 percent [in] 1981…as a result of the 1986 tax reform…[to] 33 percent. Although a few people call for even lower rates, the United States has clearly come a long way in the pursuit of economic efficiency for higher-income groups.

Rudy Penner, "Economic Growth" in *Challenge to Leadership*, Urban Institute Press, 1988, Washington, D.C.

A higher charge for the doctor-bill portion of Medicare is only one of many more steps along this road. Beneficiaries are getting $4 in medical care for every $1 they pay, with the taxpayer picking up the rest. More than 28 percent of the federal budget now goes for Medicare and social security. There is no hope, ever, of rationalizing federal finances without a significant contribution from the elderly.

Jane Bryant Quinn, *Newsweek*, October 22, 1990.



Newsweek poll, Oct. 11-12, 1990

Despite this strong sentiment, incumbents were reelected with monotonous regularity.

As part of its $52.2 billion spending bill on farming, nutrition and rural development, Congress has voted half a million dollars to renovate the birthplace of retired band leader Lawrence Welk and build tourist accommodations nearby.

Associated Press, as reported in the *New York Times*, October 23, 1990.

Ready on Deck

By Ben J. Wattenberg

In theory, everything should be going wrong for the U.S. Navy. After all, our high-tech ships, now in the Middle East, are being manned by the crisis cohort of the American population. Many of them are the alleged children of chaos: minorities, broken homes, high-school dropouts, or graduates from schools that don't teach much.

We supposedly know all about them: They can't read well, write well, or do math well. They can't find Brazil on a map. Of course, they can't compete with those Japanese and German youths.

And yet, there they are on the flight deck of the carrier Independence, near the Straits of Hormuz, doing what they're supposed to be doing. TV shots of these "dumb kids" at work show them at some of the everyday tasks of the modern Navy: with radar, sonar, radios, consoles, and keeping up the electronic guidance systems in an environment choking with fine desert sands. Many of these clucks are working 16- and 20-hour days. In the engine room, the temperature can get up to 140 degrees.

Too bad. Uncompetitive.

Capt. James Stark, now at the Pentagon, recently commanded the guided missile cruiser USS Leahy in the Persian Gulf. "These are typically blue-collar, middle-class, middle-American kids," he says. "They've joined the Navy to see the world, or learn a trade, or for patriotic reasons, or to get away from home, or from girlfriends. A lot of them have problems. In high school, the way to be one of the guys was to screw up."

But not so in the Navy, says Capt. Stark: "On a ship if they screw up, the guys turn against them…They're great. We have the best Navy ever. They didn't come into the Navy to stay out of an Army draft, the way it was before the all-volunteer service."

Somebody else has noticed. Soviet Marshal Sergei Akhromeyev recently visited U.S. military bases. After watching U.S. enlisted men, in their crisp dress, yes-sirring everything that moved, telling him they were in service to defend their country, and then go tooling off in a red convertible, Marshal Akhromeyev said, "I wish I had people like that in my army."

Marshal Akhromeyev:
"I wish I had people like that
in my army."

The Navy today is 21 percent black, 11 percent Hispanic, and with plenty of others. On the Leahy, there were Filipino, Korean, Vietnamese, Samoan, Jordanian, and — hah! — Iraqi sailors. Capt. Stark says they get along pretty well.

Discipline and TLC.

The Navy does some things our high schools don't do. There are spot drug tests. Flunk the test and you're out of there. If recruits don't hack it on ship, out of there.

But there is also some Tender Loving Care. "There's more TLC," says Cmdr. Jo Dee Jacob, the Navy Fellow at the American Enterprise Institute. "A lot of these guys never had anyone to go to," she says. "Now, their chief, as tough as he might be, often becomes a father figure when they have problems."

Is this mostly navy propaganda?
Perhaps. There are problems.
But there are also some facts
to face. The ships are
advanced machines. The crew
isn't from the Ivy League.
The ships work.

Obviously, it can't work: low-tech kids in high-tech jobs. Hasn't the Navy been to all the double-dome seminars? Haven't they heard that we're not going to be able to fill the high-ed slots in the future, because our children aren't educated?

After boot camp, most of these sailors are in technical schools for three months to one year. On some Navy ships today, there are civilian college professors. Between shifts, many sailors study American history, foreign languages, math, English, and writing.

Sounds great. Is this mostly navy propaganda? Perhaps. There are problems. But there are also some facts to face. The ships are advanced machines. The crew isn't from the Ivy League. The ships work.

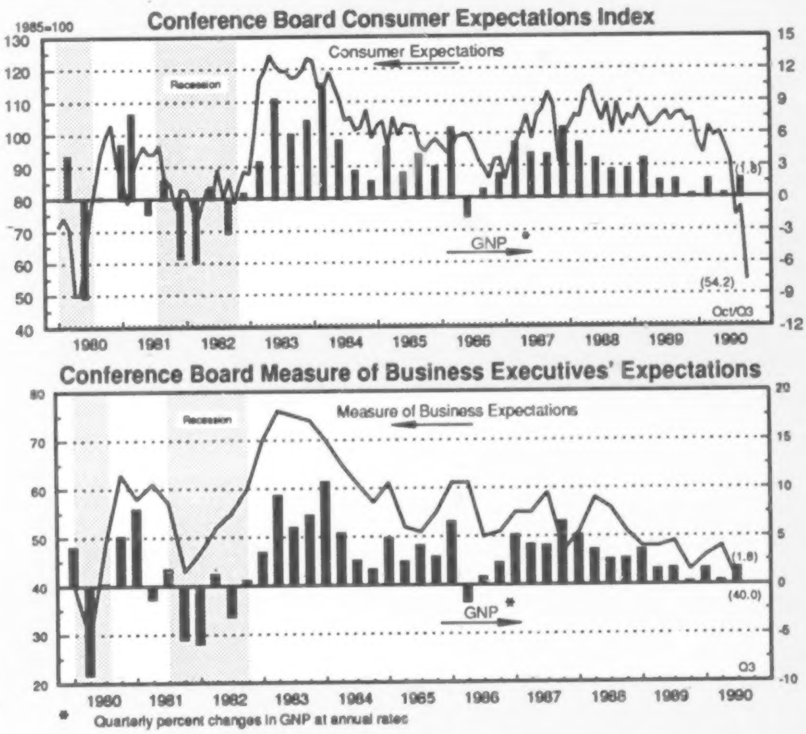
Whatever it was our terrible high schools did to these kids doesn't seem to be permanent. They can stay the course.

(Excerpted from the *Washington Times*, August 22, 1990. Ben J. Wattenberg is a senior fellow at the American Enterprise Institute.)

Conference Board Stat File

The spectacular plunge in consumer sentiment coupled with the sharp drop in help-wanted advertising signals severe business-cycle weakness. In neither case, however, has the signal been confirmed by a drop in economic activity. Spending by consumers, despite their worries, is holding up well. And unemployment has increased only a fraction of what the help-wanted index suggests. Perhaps it's only a matter of waiting for the other shoe to drop, but thus far the widely expected recession is still a forecast, not a reality. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence

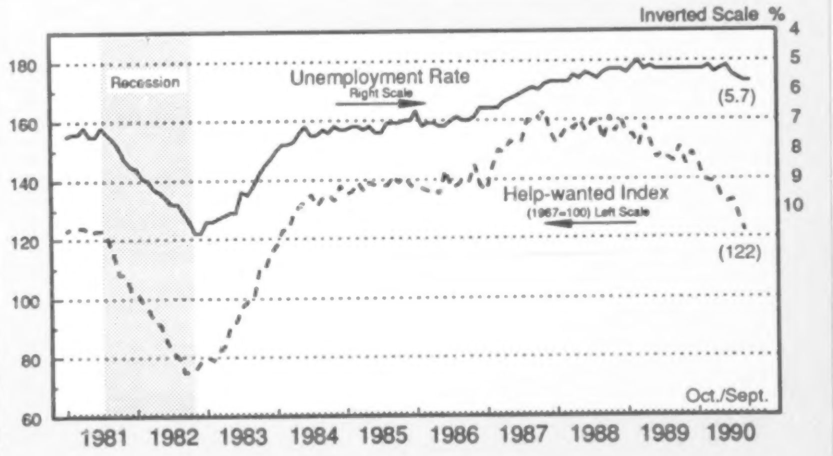

Conference Board Consumer Expectations Index

Conference Board Measure of Business Executives' Expectations

* Quarterly percent changes in GNP at annual rates

Consumer expectations have been battered by recent events.

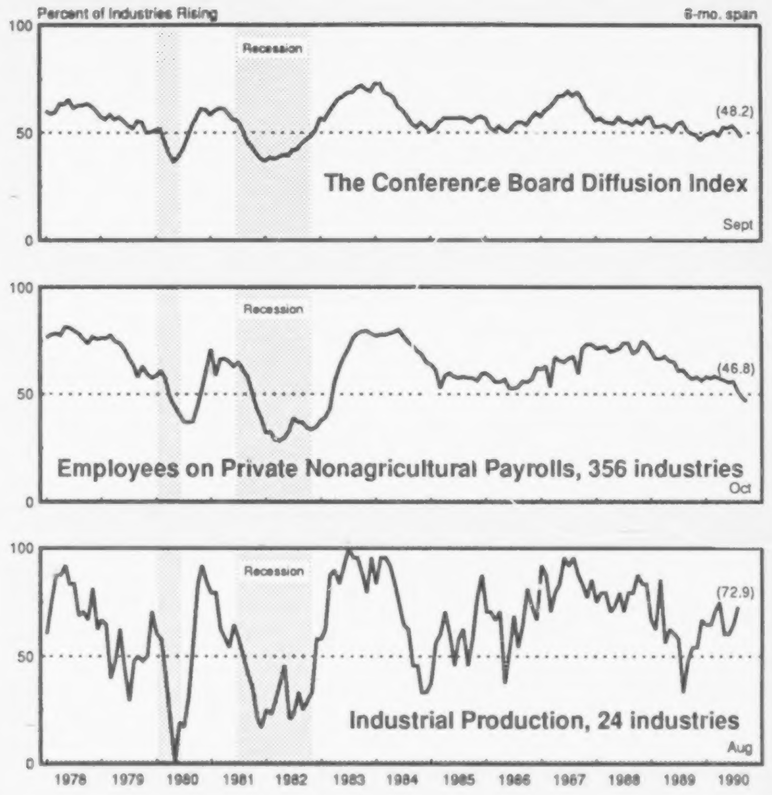
Help-wanted Advertising and Unemployment



Labor demand falling sharply.

Conference Board Stat File

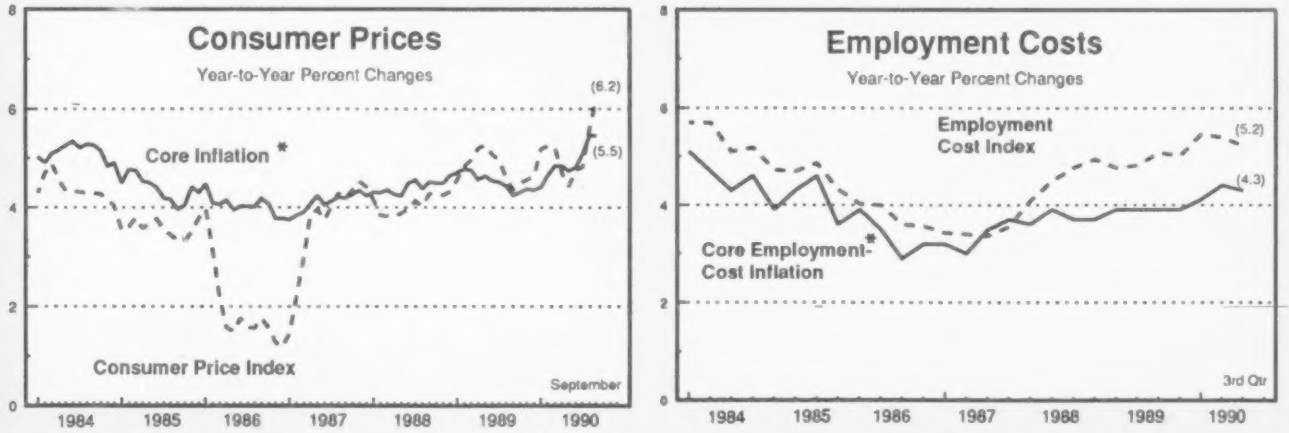
Indexes of Economic Momentum



Two of the three momentum indicators have dropped just below the neutral line.

Still shows a tendency toward acceleration.

Inflation Fundamentals



* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI)

Inside the Crystal Ball

	UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA
Date of Forecast	Oct.	Oct.	Oct.	Oct.	Oct.	Oct.	Oct.	Oct.

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%	%	%	%	%		
Actual	1990 1Q	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1Q 1990	Actual
	2Q	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q	
Forecast	3Q	0.7	0.7	0.1	0.1	1.8	0.7	1.6	1.1	3Q	Forecast
	4Q	-3.0	-2.0	-1.0	-2.0	1.1	-2.3	-1.3	-1.1	4Q	
	1991 1Q	-3.1	-1.6	0.0	-1.3	2.0	-2.5	0.1	-0.6	1Q 1991	
	2Q	2.5	0.4	-1.0	-0.9	1.5	-0.6	0.8	1.2	2Q	
	3Q	6.8	2.6	0.5	0.9	1.8	2.0	2.4	1.9	3Q	
	4Q	6.0	2.9	2.9	2.5	2.0	2.8	2.7	1.9	4Q	
	1992 1Q	2.9		4.0		3.5	3.5	3.7	2.6	1Q 1992	
	2Q	1.6		4.0		2.5	4.0	3.3	2.5	2Q	
	3Q									3Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1989 4Q	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	1989 4Q	Actual
Forecast	1990 4Q	5.6	4.9	5.2	5.2	4.9	5.0	4.1	4.3	1990 4Q	Forecast
	1991 4Q	3.5	4.2	4.6	4.5	4.8	4.1	3.7	5.2	1991 4Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1990 1Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	1Q 1990	Actual
	2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q	
Forecast	3Q	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	3Q	Forecast
	4Q	6.0	5.9	5.9	5.9	6.0	6.0	5.9	6.0	4Q	
	1991 1Q	6.7	6.3	6.0	6.2	5.8	6.4	6.2	6.4	1Q 1991	
	2Q	6.9	6.6	6.2	6.6	5.8	6.8	6.4	6.7	2Q	
	3Q	6.6	6.8	6.2	6.7	5.8	7.0	6.4	6.8	3Q	
	4Q	6.1	6.8	6.0	6.7	5.8	7.1	6.4	6.9	4Q	
	1992 1Q	5.8		5.9		5.6	7.0	6.3	6.9	1Q 1992	
	2Q	5.5		5.8		5.5	6.8	6.2	6.8	2Q	
	3Q	5.3		5.7		5.5			6.7	3Q	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
and at
additional mailing offices

Statistical Reference Index
Acquisitions
4520 East West Highway
Suite 800
Bethesda, MD 20814

R4105-80 A

The Conference Board

Volume 2, Number 1 January 1991

Economic Times

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Editor's Note:

Lots of goodies for this first issue of the new year. The Colloquium explores a major new question about the current business cycle. Next, Ken Chilton enlightens us about a once-dull now-contentious topic: how to get rid of our garbage. Then some insightful thoughts from London about political leadership and (thanks to long-time friend Lowell Harriss) about justice in Ancient China. These are followed by the second edition of our special quarterly feature: The Industry Outlook Report. After that you will find a synopsis of how the Continental Illinois Bank was rescued six years ago, and a look at the 1990 performance of the world's 10 largest stock markets. And finally, our Stat File and Crystal Ball. All in all, quite a tasty smorgasbord.

I trust it's not too late to wish everyone a pleasant and prosperous 1991.

Ed Fiedler

Maxim of the month:

The Eiffel Tower is the Empire State Building after taxes!

Senator William Roth in the Tax Foundation's "Tax Features."

Does Debt = Disaster?

Q: Debt is going bad everywhere: Leveraged buy-outs, home mortgages, S&Ls, even the biggest commercial banks. The daily headlines about this crisis tell us the world is coming to an end, right?

A: *The headlines say so, yes, but the conclusion may or may not be valid. As always, the headlines exaggerate the bad news. Beyond that, how serious this is depends on your perspective: From the (micro) point of view of a threatened financial institution, the risk of the world coming apart may be high. From the (macro) point of view of the economy as a whole going into something like a Great Depression, the risk is small.*

Q: But what if a major bank or three go under?

A: *Big problems for their stockholders and top executives, but it shouldn't impact heavily on the economy as a whole. It should sort itself out out like the rescue of Continental Illinois. The FDIC takes over, installs new managers, the Fed temporarily supplies extra credit to the banking system, and most everything goes on as before. (For a more detailed review, see p. 7.)*

Q: What if the FDIC runs out of funds?

A: *The President and Congress, after the usual sound and fury trying to fix the blame elsewhere, will tell the Treasury to replenish the FDIC's resources.*

Q: Whoops! Not so fast! The Treasury has to borrow those extra billions. Won't that raise interest rates and push the economy still deeper into recession?

A: *It shouldn't. The Federal Reserve (in effect) prints the extra money but, in contrast to the usual process, when the FDIC passes the money through to keep John Q. Citizen's bank balance safe, nothing much changes in the financial system. It's a wash transaction: The dollars borrowed from the capital markets by the Treasury are put directly back into the capital markets by the bank or thrift without financing any new economic activity. The one change is the extra billions of Federal deficit, but during a recession the extra deficit is easy to finance, and inflation is easing not accelerating.*

Q: So, no problem?

A: *Whoa! I'm arguing "no disaster," not "no problems." Many banks, thrifts and others have serious problems, such as declining real-estate values, increased FDIC fees, and the need to strengthen their capital. At the macro, economy-wide level, we have the problem of inadequate saving and investment and from a shorter perspective we have a recession. Further, the new regulatory requirement that banks increase their capital base substantially may seriously complicate the task of dealing with the recession.*

Q: How so?

A: *By inducing many banks to tighten their lending standards, which if widespread could stifle the recovery. In response — assuming this is a full-fledged recession — the Fed will probably ease credit more aggressively than usual — which means that interest rates could fall even more than normal for a recession — and it's also likely the regulators will postpone the timetable for increasing bank capital. But the impact of this regulatory change is an important new issue, which is why we asked the Colloquium to discuss it — on the next page.*

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

A special twist of the current business cycle is the impact of troubles in the financial sector of the economy. The S & L crisis is the best known part of that. The fall in real estate values probably has the most widespread impact. And the enhanced capital requirements imposed upon commercial banks by their regulators may be the most significant for recovery prospects.

Question:

Will the fragility of the financial sector deepen the recession or retard the subsequent recovery or both? If so, what should the policymakers be doing in response?

Robert G. Dederick
Northern Trust Company

Fragility, what fragility? Surely the questions must refer to some other nation, perhaps on the opposite side of the Pacific. But, if perhaps I am mistaken, the proper answer to Query #1 is "it all depends" — on public policy. If regulatory policy is properly supportive and monetary policy is appropriately stimulative, then financial fragility need not be a meaningful constraint. But if these policies are not as stated, then similar actions will have to be taken later in any event (thereby answering Query #2).

Andrew F. Brimmer
Brimmer & Company

The "credit crunch" will make the recession deeper and retard recovery. Without it, real GNP would probably decrease by 1 percent from the third quarter of 1990 through the first quarter of 1991. Instead, we may suffer a three-quarter decline of 1.5 percent. To ease the adverse impact, bank examination standards should be relaxed further. The January 1 increase in bank capital requirements should be delayed, and bank reserve requirements should be cut by 10 percent.

Murray Weidenbaum
Center for the Study of American Business

The vulnerability of financial institutions underscores the weaknesses in the real economy. The Fed should start paying interest on compulsory deposits by banks (known as "reserves") and bank regulators should think hard before promulgating new requirements. Congress is hardly helping by waiting until a downturn to raise taxes and impose expensive new regulatory restrictions on business. Government loves to sympathize with voters hit by recession while taking dumb pro-cyclical actions.

James Tobin
Yale University

The 1980s recovery survived stock market crashes and S&L disasters. Now, with bad loans threatening banks, can the Fed engineer a 1990s recovery? Sure, if Greenspan eases promptly and decisively. The driving force will be exports rather than housing. Low interest rates are still the key: they lower the dollar. Despite recession and Brady's sympathy for beleaguered bankers, Congress must protect taxpayers from again holding the bag for imprudent and under-supervised financial institutions.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Garbage!

An interview with
Kenneth Chilton
Center for the Study of
American Business

Economic Times: Am I correct, Mr. Chilton, in describing you as "one of the world's great garbage economists?"

Chilton: *Hmm... I don't know whether to be flattered or insulted. I think I will just plead the Fifth Amendment.*

ET: What should we do about the garbage crisis?

Chilton: *The first thing to do is to quit treating it as a* ***crisis****. It's properly regarded as a* ***problem*** *and a* ***challenge****, and in some ways as an* ***opportunity****. To think of it as a* ***crisis****, however, interfere's with sensible analysis and a rational response.*

ET: What should be done?

Chilton: *There are really only four basic options: Source reduction, recycling, incineration and landfilling. We need a fully integrated approach using those four methods based on the criteria of safety and cost-effectiveness.*

ET: According to some environmentalists, we should only "reduce and recycle." Given the problems of incineration and landfilling, isn't that a good idea?

Chilton: *Reduction and recycling have nearly reached the level of public support given motherhood and apple pie. But no, we should not limit our options to those two, not in a world of limited resources. That's what I had in mind in calling for an* ***integrated*** *approach, meaning a systematic look at all four options, as opposed to the* ***ad hoc*** *approach so often used now. For most solid waste, source reduction and recycling are just too expensive. As long as we have other important things to do with our money, we don't want to spend more than we have to for satisfactory garbage disposal.*

> *We're running out of safe landfill space? No! That's one of the pernicious myths of the garbage biz.*

ET: Are you saying we shouldn't make any special effort to reduce the amount of waste?

Chilton: *We should make a full effort at source reduction everywhere we can at reasonable cost. We should, for example, build the cost of disposal into the initial price of environmentally difficult products such as rechargeable batteries. What we shouldn't do, in most cases, is to impose outright bans on a substance or a product, because such bans, in addition to being expensive, often produce unintended side effects. For example, in the 101st Congress, a solid waste bill surfaced in the Senate that would have prohibited the use of cadmium. The primary target seems to be the cadmium used in rechargeable batteries. But artists are outraged, understandably, because there is no acceptable substitute for cadmium in producing bright red, yellow and orange hues. Use of cadmium by artists would hardly seem to be a significant danger to society.*

ET: What about recycling? Can't we recycle our garbage much more than we do now?

Chilton: *For some things, yes. We do a pretty good job on aluminum now — we're up to somewhere between 25 and 45 percent recycled--and we should be able to take that percentage a bit higher. But aluminum accounts for only 1 percent of municipal solid waste, so even a major improvement isn't going to make a significant dent in the total garbage disposal task. Perhaps the greatest potential for beneficial recycling is residential yard wastes, which make up nearly 20 percent of municipal solid waste.*

So I'm all in favor of recycling where it makes economic sense. But there is too much garbage that simply can't be recycled. Thus I worry about cities that are relying on greatly increased recycling rates to head off a crisis. For example, Seattle decided to increase its recycling rate to 60 percent by 1998 rather than site new landfills or build an incinerator. The city currently recycles at a 37 percent rate, the highest of any major U.S. city. It is possible however, that Seattle's current success could be tomorrow's crisis. Given the long lead times to obtain permits and build new landfills or incinerators, the city is taking a big risk by placing most (if not all) of its eggs in the recycling basket. Will Seattle officials prove to be far-sighted prophets or merely wishful thinkers? Only time will tell.

ET: That leaves incineration and landfilling. Aren't both rife with problems?

Chilton: *Neither one is ideal or problem free, of course. But both have important roles to play in an integrated waste management system. Public concern about incinerators focuses on the unhealthful residues of metals and organic chemicals in air emissions and ash. Just last year, however, the Municipal Solid Waste Task Force in its final report to the EPA concluded, "although combustion is not risk-free, a state-of-the-art combustor that is well operated should not present a significant risk to human* *health and the environment." That is less of an iron-clad guarantee than many environmentalists are after, but it should be enough for most people.*

ET: From here it sounds like less risk than we take everytime we get into an automobile. What about turning garbage into energy?

Chilton: *A great idea, but the economics of waste-to-energy plants is less than compelling. The plant costs are high. But when we take account of the avoided cost of alternative garbage-disposal methods, sometimes it can pay to produce energy by burning garbage.*

ET: Let's go back to landfills. How can they be part of the solution when we're running out of safe landfill space?

Chilton: *We're not. That's one of the pernicious myths of the garbage biz. It's true that heightened environmental awareness has increased resistance to new landfills — despite the significant decline in environmental risk from these facilities — but we are not running out of geologically suitable sites. A recent environmental survey of less than half of New York State identified sites totaling 200 square miles.*

ET: But how about plastics, since they don't biodegrade, shouldn't we keep them out of landfills?

Chilton: *Another myth. Plastic is not the overwhelming presence it's cracked up to be. All plastics account for only 7 percent of municipal solid wastes, and polystyrene — public enemy number one in the environmentalist's view — only a few tenths of one percent. Furthermore, the fact that plastic doesn't biodegrade is as much a virtue as a sin. It means that plastic doesn't release chemicals into the groundwater.*

ET: Looking ahead, how do we go about dealing with the problem?

Chilton: *Let me suggest two principles to guide future action. First, garbage is primarily a local problem. At the federal level, the EPA should play a key role collecting and disseminating information. And state officials can serve as agents to resolve disputes among localities. Otherwise, local authorities are normally best positioned to make garbage-disposal decisions.*

> *The clear motivating factor in Seattle's sucessful program is the "pay as you throw" system of trash hauling.*

Second, we should maximize the use of market incentives. The greatest "market failure" connected with solid waste disposal is the distortion of market incentives resulting from municipal systems that charge flat fees for garbage collection. Cities that collect trash from households as a community service or that charge a single fee regardless of the amount of trash put out by the household are encouraging wastefulness. Consumers are not being made aware of the true disposal costs resulting from their buying and discarding practices.

Seattle's successful recycling program is fundamentally a story of the power of marketplace incentives to change behavior. Although the volunteer efforts involved in Seattle's success have gained a great deal of attention, the clear motivating factor is the fact that residents are faced with a "pay-as-you-throw" system of trash hauling. Homeowners pay $10.70 a month for a 19-gallon mini-can but $31.75 for three full-size, 32-gallon garbage cans. Curbside recycling of plastic beverage bottles, glass, cans, newspapers and other waste paper is free. Four out of five Seattle households recycle and 90 percent put out one or less cans of garbage a week. Basically, it is the high incremental cost for additional garbage cans that has placed Seattle residents at the top of the recycling chart.

ET: But how do you persuade people to accept a landfill in their locality?

Chilton: *Here, too, economic incentives provide a way out of the NIMBY — Not In My Backyard! — syndrome. Citizens do not want recycling centers, incinerators and landfills in their backyards because they reduce property values and adversely affect other nonpecuniary aspects of home ownership — a quiet neighborhood, less traffic congestion and the like. The simple (but not easy) solution is to compensate property owners for their losses. An indirect form of compensation is to provide a public benefit — a firehouse, a park or civic center, or road improvements. Or restitution can be more direct, such as a lump-sum payment, or payment of property taxes for the homeowners.*

ET: Sounds like **bribery** to me!

Chilton: *It could go by many names, both good and bad: hush money, payola, reward, economic incentive. But whatever you call it, the point is that those enjoying the benefits of the waste disposal facility should offset at least some of the costs that are imposed on the areas surrounding the facility.*

ET: Final question: There have been a fair number of reports on this issue in the newspapers and on TV. Have they helped or hurt?

Chilton: *Both. Getting better information to the public is important, and some of the media attention has changed individual and business behavior for the better. But much of the information has been inaccurate, and that hurts. In short, some garbage exposés have been "talking trash."*

ET: Have we talked enough trash for now?

Chilton: *Yes, perhaps we have.*

ET: Thank you very much, Mr. Chilton.

Kenneth Chilton is Associate Director of the Center for the Study of American Business at Washington University of St. Louis. This interview was based on his study, "Talking Trash: Municipal Solid Waste Mismanagement," published by the Center, September 1990.

Quotable Quote

Leadership? *by Jonathan Wilmot*

Reagan has gone, and Bush seems to have got himself trapped in the beltway. In the Soviet Union, even outsiders no longer see Gorbachev as master of the universe. Deng is rumored to be ill, and dying. Kaifu's days look numbered. In Europe, the Delors game plan is going off the rails, and Mrs. Thatcher is history. In the Gulf, the allies muster more firepower than willpower…Never mind the "borderless world," it's the prospect of a rudderless world we now have to face…

A new world order is struggling to be born, and with it a new spirit of the age. It is natural in such times to hanker after strong and decisive leadership to control and shape all this chaos. Natural also to contrast our present leaders with the early days of Reagan, Thatcher, Volcker, of Gorbachev himself. To observe with sadness, or to gloat, that their reputations are tarnished, their convictions seemingly out of date. To fret that government by opinion poll is driving out integrity and steadiness of purpose. To sense that prosperity has both revived the politics of envy and given electorates a fresh taste for the soft option.

Still, I can't suppress some heretical thoughts about this leadership debate. Stalin, for example, would qualify as a "strong" leader, able to impose order on chaos by utterly ruthless cunning. More to the point, conviction politics may be inappropriate, too risky, for times of massive flux. Quiet persistence, flexible response, a talent for cultivating alliances, and avoiding confrontation until it is clearly worthwhile might serve the case better. Real leadership might entail lying in wait for those rare occasions when swift, decisive action is genuinely possible. (In the British case, this sounds more like Major than Thatcher. In the U.S. case, Bush at his best.)

Jonathan Wilmot is Director-Economics at Credit Suisse First Boston Ltd. (London). This commentary is excerpted from his "Market Focus," 16th November 1990.

The Judicial System, Then and Now

Then — Ancient China:

There was a complaint during the reign of the Emperor Kanghsi, one of the greatest Manchu Emperors, about the corruption and tyranny of the courts. The Emperor received a petition, considered it awhile and issued this decree:

"The Emperor, considering the immense population of the empire, the great division of territorial property and the notoriously litigious character of the Chinese, is of opinion that lawsuits would tend to increase to a frightful extent if people were not afraid of the tribunals and if they felt confident of always finding in them ready and perfect justice.

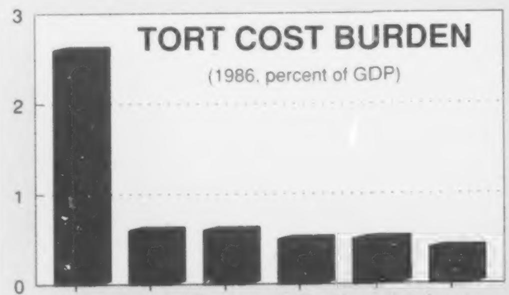
"As man is apt to delude himself concerning his own interests, contests would then be interminable and the half of the em[illegible] would not suffice to settle the lawsuits of the other half. I desire, there[illegible] that those who have recourse to the courts should be treated without any pity and in such a manner that they shall be disgusted with law and tremble to appear before a magistrate.

"In this manner the evil will be cut up by the roots; the good citizens who may have difficulties among themselves will settle them like brothers by referring to the arbitration of some old man or the mayor of the commune. As for those who are troublesome, obstinate and quarrelsome, let them be ruined in the law courts; that is the justice that is due to them."

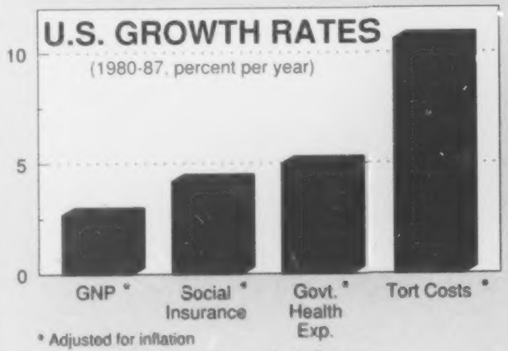
Judicial reform, under those conditions, was naturally difficult.

Excerpted from "The Geography of China,"by Frank Johnson Goodnow, President (then) of Johns Hopkins University. *The National Geographic Magazine*, June 1927.

Now — Present Day U.S.A.



Includes personal injury, property damage, product liability, and malpractice costs.



* Adjusted for inflation

Source: Tillinghast, a Towers Perrin Company.

Industry Outlook Report

January 1991

Overview

Edgar R. Fiedler, The Conference Board

The theme among our panelists this month is a business cycle without tears. The recession that was only a strong possibility 3 months ago is now universally accepted. Among those who focus on the general business cycle, the feeling is that the low point will come early in the year but the recovery in sales is likely to be modest rather than robust.

The tenor of the others in the group is consistent with this moderate view of the downswing. It's not looked upon, necessarily, as a routine recession, but there is no hint of panic or anything close. No analyst leaves the impression that his or her industry is headed for insurmountable trouble. Few see any bright light at the end of the tunnel, although several panelists cite international orders as a specific source of strong demand.

Projections of next year's profits, as usual, call for extra uncertainty and caution. Most of those who mention the profits outlook are pessimistic, including agriculture, forest products and, most seriously, steel. Packaged foods is a distinct exception, with profits projected to rise in 1991, albeit at a slower rate.

In several industries, our panelists took comfort from a longer perspective. In telecommunications, for example, telephone lines and long-distance calling have increased every year for the past half century. And our specialist on packaged foods is looking for average annual profits growth of 10-13 percent for the decade of the '90s. Even financial services are expected to return to normal profitability, although not until after the industry completes a massive and painful restructuring over a period of 5-10 years.

In general, the mood of our panelists avoids the extremes. Mostly they are just subdued and sedate. The surprise, in view of the stage of the cycle, is that nothing approaching anxiety or fear appeared.

Steel

Elizabeth A. Bossong Consultant

The outcome in the Persian Gulf is unknowable, but I have assumed that oil will average no higher than $25 a barrel, the collapse in consumer confidence will be at least partially reversed, and there will be no additional credit crisis and some monetary easing. Despite those perhaps-optimistic assumptions, there will be little to cheer about in the economy's performance.

Total domestic steel consumption declined by about a million tons last year as higher capital spending, strong export demand for machinery, gains in energy markets, and public-construction increases only partially offset the sharp declines in automotive production and housing. Steel shipments, however, slightly exceeded the 1989 total of 84 million tons, aided by both customer strike-hedge inventory building late in the year and some price hedging.

The dramatic improvement in the steel trade deficit has been vital to the recovery in steel over the past few years. Between 1984 and 1989, when domestic usage was essentially unchanged, the gains in foreign trade — from a 25 million ton deficit to one of 13 million tons — brought about a 10 million ton increase in industry shipments. Further trade improvement is unlikely in 1991 but, given a fairly strong world economy, the weaker dollar and reduced domestic usage should preclude deterioration.

In 1991, machinery output will slow in reaction to the decline in corporate cash flow, partly offset by still strong export demand. A sharp drop is probable for private nonresidential construction moderated by a relatively stable public construction picture. While the trend should be upward during the year, on an annual basis little recovery is expected in housing and automotive uses. Total steel usage will decline by about 2 percent. Lower consumption and customer inventory cutting, no longer offset by an improving steel trade balance, will drop shipments to 77-80 million tons. Higher costs, lower operating rates, and little if any price relief suggest a further decline in industry earnings. Given the efficiency of the industry and the decline in the dollar, a return to the ruinous price cutting and huge losses of the 1982-1986 period seems unlikely.

	1989 actual	1990 estimated	1991 projected
Industry Shipments *(Tons, Mil.)*	84.1	+1%	-8%
Net Income *($ Bil.)*	1.5	-57%	-60%

Petroleum

James W. Hanson
Consultant

World oil markets have once again been buffeted by developments in the Middle East. Much as in 1973 and 1978-79, oil prices soared, consumer and business confidence plummeted, and economists began marking down their forecasts. Thus far, however, the third oil shock appears less menacing, both to oil markets and to economic prospects, at least in the industrial world.

Oil markets and prices would have already returned to pre-crisis sluggishness if the political trigger were simply the embargo on exports from Iraq and Kuwait. In response to sharply-higher output, together with lower demand prompted by higher prices and slower economic activity, commercial oil stocks are actually at or above year-ago levels.

Comfortable demand-supply balances notwithstanding, oil prices will continue to include a war-risk premium so long as Saddam Hussein refuses to abide by UN Resolutions. The outbreak of war could well validate analysts' projections of $60 oil, at least in the initial stages. On the other hand, the oil-consuming world is far less vulnerable to disruption nowadays. The estimated billion barrels OECD countries hold in strategic storage is equivalent to four months of Saudi production at today's stepped-up rate.

Even if prices remain in the $25-30 range, fully half again year-ago levels, the adverse impact on inflation and economic growth need not be catastrophic. First, oil would still be a relative bargain, with real prices little higher than before the second shock in 1978 — especially in strong currency economies such as Germany and Japan. Second, the industrial countries on average use 40 percent less oil to generate a unit of GNP than in the early 1970s.

In sum, higher oil prices have dampened economic prospects, particularly where, as in the US, recession was already coming. But an early peaceful resolution of the Gulf crisis would find oil prices plunging to $20, perhaps lower, and confidence rising once again. Unlike the earlier oil shocks, OPEC members have been promoters of price moderation and market stability. Moreover, consuming country governments have resisted "knee-jerk" policy responses, particularly oil price and profit controls. Higher oil prices have boosted earnings for both government and private producers, but most of the latters' gains have been offset by thinner margins in refining, marketing, and chemical segments.

Forest Products

Lynn Michaelis
Weyerhaeuser

The situation in the forest products industry is a good benchmark for the extremes emerging in the U.S. economy.

Growth in demand for paper products slowed during 1990 in line with the overall economy. Strong growth in export sales has offset slower domestic sales. North American producers are in their strongest competitive position since 1979 relative to Scandinavian producers. The biggest challenge for these businesses in 1991 will be the capacity growth fueled by strong profits and high investment levels from 1987 through 1990. Profits and investment will decline further for this segment in 1991 as demand growth slows during the recession.

The situation in the paper industry is sedate, however, when compared to the dramatic decline in the forest products industry in 1990. First, housing construction dropped due to tougher lending standards. Second, consumer spending for furniture declined in the second half of the year. As a result, product demand dropped sharply (see table). Product prices plummeted in July and dropped further in October. Lumber product prices are 25 percent below year-ago levels. Plywood prices are down 40 percent. Industry margins are now back to or below the depressed levels of 1982.

The drop in margins is particularly severe for western lumber producers, who once again bid timber values too high. Environmental pressures from the spotted-owl decision triggered speculative fever in 1989. Timber costs soared from below $200 per thousand board feet in 1988, to over $400 by early 1990. At today's prices, a producer would lose money on timber purchased at 1989 prices. Thus, lumber production in the West has dropped 26 percent, compared to only 5 percent in the South.

We expect demand to bottom in the first half of 1991, 12 percent below 1988 peak levels. With housing starts averaging 1.0 -1.1 million units in 1991, prospects for this industry do not look bright.

	1989 actual	1990 estimated	1991 projected
Lumber Demand *(BBF)*	47.8	46.4	42.5
Doug. fir *2x4 price*	$264	$243	$230
So. Plywood *1/2" price*	$211	$180	$165

Financial Services

Karen N. Horn
BANK ONE,
CLEVELAND

Financial services institutions face substantial challenges in the 1990s. All banks must learn how to make money in an increasingly competitive marketplace. Some banks have dealt with the changing marketplace well. Although total industry profit performance is disappointingly low, and many banks are earning insufficient returns, a few banks are extremely profitable. Over the last 40 years, banks, thrifts, and insurance companies have lost market share to largely unregulated providers of financial services such as money market funds. And currently, many banks (and insurance companies) are facing real estate loan problems. This problem arose in part because banks' traditional customers, large corporations, increasingly issued commercial paper rather than borrowing from banks. Thus, real estate developers became particularly welcome customers as substitutes for the traditional borrowers. Because of excessive residential and commercial construction in the 1980s, the supply of developed real estate is presently outstripping demand; for this and other reasons, bank profitability has dropped to its lowest level in several years.

Outlook

Many analysts are unconvinced that financial services companies will significantly improve their profitability any time soon. There is much over-capacity in the industry. Regulatory changes (already made or in the works) will restrict financial institutions' cheap access to the federal safety net: deposit insurance, the Fed discount window, and the payments systems.

We will see a massive restructuring within the next five to ten years resulting in a consolidation of the industry. Along with the restructuring will come tighter management. Surviving banks will be far more focused on their markets and the bottom line. Once this process is complete, I would expect the financial services industry to once again generate profits at historical levels.

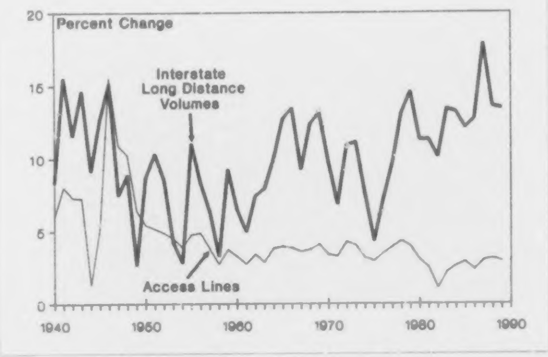
Telecommunications

Kenneth H. Militzer
AT&T

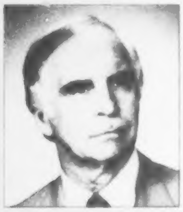
The U.S. telecommunications industry was transformed in the 1980s by a series of dramatic events — the breakup of the Bell system, the loss of AT&T's monopoly in long distance, partial deregulation, the onset of foreign competition, and dramatic technological advances. However, one factor driving the industry did not change — the need to communicate. Indeed, the new products and services spawned in the post-divestiture era have made communications more important to our lives than ever before.

The ever-growing need to communicate — to move and manage information -- has caused both the number of telephone lines and long distance volumes to grow in each and every one of the past 50 years (see accompanying chart). However, with a recession seemingly underway, it is especially pertinent to recognize another historical fact — that growth in both telephone lines and long distance messages has slowed during each of the previous postwar recessions. That situation — slower but continued growth — is likely to continue in 1991. In the services side of the industry, which accounts for the bulk of its revenues, that means growth this year is unlikely to match last year's estimated gains of 10-to-11 percent in long distance volumes, 6-to-7 percent in toll revenues, and 3-to-4 percent in local exchange carriers' revenues.

On the equipment side, shipments in 1990 were supported by a 30 percent surge in exports — a surge that reduced the U.S. trade deficit in telecommunications equipment from $1.9 billion in 1989 to about $600 million in 1990. Continued growth in exports should partly offset the recession's impact on this part of the industry in 1991. Even so, the growth in shipments of telecommunications equipment in 1991 is likely to fall considerably short of last year's 11 percent rise.



Agriculture



John Schnittker
Schnittker Associates

For the fourth consecutive year, U.S. farmers earned record incomes in 1990. At $51 billion, overall net income is one third above 1986, the last year of the recent farm recession. Cattle and hog prices rose as red meat supplies declined 3 percent, and expansion of poultry production just offset the reduced red-meat supplies. Farm prosperity in 1990 was especially important to the inter-mountain and western states, still laboring under a serious drought.

Grain prices declined in the second half of 1990 on the heels of record world harvests, and they may decline well into 1991. Grain farmers, however, are protected by government payments, which increase when prices fall. Grain exports will also fall this season because of huge supplies abroad, the confrontation with Iraq, and financial distress in the USSR.

U.S. farmers are apprehensive about 1991. The farm bill and federal budget policy reduced planned government spending on farm programs for 1991-95 by one fourth. A recession may reduce the demand for red meats, the bedrock of farm prosperity in 1990. Farmers fear a trade war in 1991 and 1992. The U.S. would fight the European Community's farm subsidies by dumping our grains and oilseeds on world markets at low prices.

Finally, farm costs will be $4 billion higher than in 1990 if oil prices are in the area of $35 per barrel. Take away $2 billion in government subsidies, and a similar amount from lower livestock prices, and farmers could face a 10-15 percent income drop. This will slow the purchase of machinery and other capital items, and add slightly to the general economic recession.

Retail food prices, up over 5 percent in 1990, should rise by only 4 percent in 1991, almost entirely as a result of general inflation. Farm prices, on average, may be slightly below 1990 levels.

	1990 estimated	1991 projected
Farm income	+4%	-10 to -15%
Retail food prices	+6%	+4%

Packaged Foods

G. Leonard Teitelbaum
Merrill Lynch

The old adage that "no matter what happens, people have to eat" forms the underlying premise that food-industry profits should continue to increase in 1991 — albeit at a somewhat slower pace than in the recent past. After a general rate of 12-14 percent earnings growth in the 1980s, a 10-13 percent growth rate in the 1990s seems to be a reasonable expectation, given the structural changes that have occurred in the recent past. Food giants have gotten back to basics; they have divested much, if not all, of their non-food businesses and increased the competitive temperature. Commodities prices, which peaked after the drought of 1988, have declined, which has allowed an increase in advertising and promotional budgets.

A recession may well alter the mix of product sold by food companies: Products perceived to be luxury items may give way to more basic items. The more basic items, moreover, generally carry better operating margins than do many less-mature products. We continue to project growth in the convenience-oriented microwave-product category and, depending on the length and depth of a recession, expect growth in the refrigerated foods category to be particularly newsworthy.

An issue that has begun to surface and that could affect the packaged food industry after 1991 deserves some mention. The issue is company size. In the food industry, size has typically meant leverage, which in turn has meant shelf space, and that has meant dollars. Although that premise has not necessarily changed, what has changed is the perception of what constitutes a large company. At present, two packaged-food companies are projected to have revenues of more than $20 billion for 1991. Analysts used to regard as large a company with $6-8 billion in revenues, but that amount may only constitute a medium-size company in the 1990s.

International opportunities for several food companies may also receive more attention in 1991. Depending on country and product line, companies' international divisions could add 1-2 percentage points to the internal growth rate of the industry.

The Continental Illinois Rescue: Many Parallels to 1990

by Raphael Soifer and Nancy A. Bush

If another "run" were to begin tomorrow at a money center bank, the Continental example from 1984 sheds considerable light on the sequence of steps likely to be followed.

The first steps taken in the case of Continental Bank were the reassuring statements made by the bank itself and by the Comptroller of the Currency. When those proved insufficient, the authorities made certain that short-term liquidity was provided to the bank. This was done at first through lending at the Fed discount window, then by organizing a line of credit among major U.S. banks, a technique repeated numerous times since to help various regional banks.

The Fed's reclassification of Continental Bank to the "extended credit" category meant that the funds it could make available to the bank were essentially unlimited

When that proved inadequate by itself, the FDIC made a direct investment of subordinated capital, a step that had earlier been sufficient to save First Pennsylvania. In Continental's case, the investment was accompanied by a blanket liquidity guarantee which ultimately saved the bank; although the run on the bank continued for several months, action by the Fed and FDIC under their liquidity guarantee enabled withdrawn funds to be replaced and services to bank customers to continue without interruption. The Fed's reclassification of Continental Bank to the "extended credit" category meant that the funds it could make available to the bank were essentially unlimited.

Once it developed that Continental's capital would be used up by mounting credit losses, with the liquidity guarantee in place the authorities then sought to arrange the merger of Continental into a healthy institution. That step worked well in the rescue of Seattle First, which was acquired by BankAmerica in 1982. Only after Continental's merger possibilities had been exhausted did the regulators' attention turn to the rescue package that was finally adopted.

Lessons for Today's Investors

- One lesson has already been learned by the nation's money center banks, which today are far more liquid and able to withstand shocks than was Continental in 1984. In addition to the factors on the asset side of the balance sheet, such as the ratio of bank loans to investments, banks have done a lot of work on their liability mix, greatly reducing reliance on volatile purchased funds. In addition, secondary market trading in bank loans is far more prevalent today than in previous cycles, making banks' loan portfolios themselves more liquid than they used to be.
- At no point in Continental's decline and eventual fall were the interests of the bank's depositors and general creditors ever allowed to be at risk. On the other hand, the shareholders of the holding company were essentially wiped out and only a unique set of circumstances protected its bondholders.
- The size of the FDIC's bank insurance fund did not pose a meaningful limitation to its role in Continental Bank's rescue, nor do we believe it would have even if the bank had been considerably larger. The reason for this was and is the FDIC's continuing ability to borrow from the Federal Reserve system, which as we have seen is capable of acting essentially without financial limitation to protect the banking system. Nor was there ever any question of the authorities being able to act quickly enough to save the bank.

One lesson has already been learned by the nation's money center banks, which today are far more liquid and able to withstand shocks than was Continental in 1984.

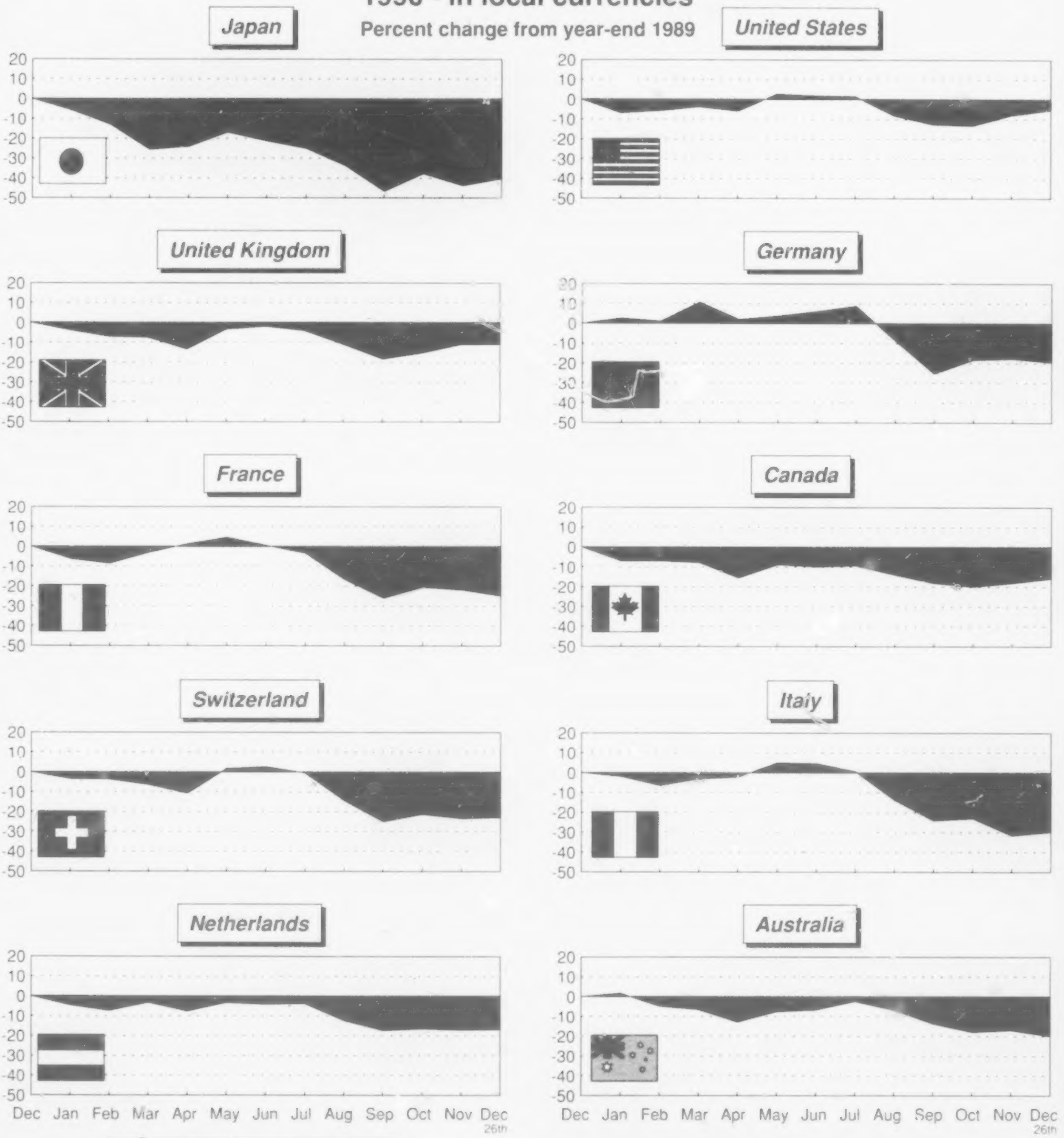
- To be sure, the rescue was not without cost. Part of the cost was the impact of the additional reserves created by the Fed in the course of the rescue--their impact on inflation and interest rates. However, as measured by the market for long-term Treasury bonds, the negative effect was short-lived. History, then, does not support the arguments of those who worry that a banking crisis would result in massive inflationary pressures and a bear market in bonds.

Excerpted from Brown Brothers Harriman & Co., *Banking Outlook*, November 26, 1990.

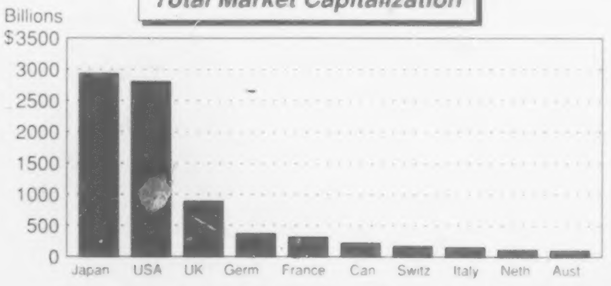
Stock Prices Around the World

1990 - in local currencies

Percent change from year-end 1989



Total Market Capitalization



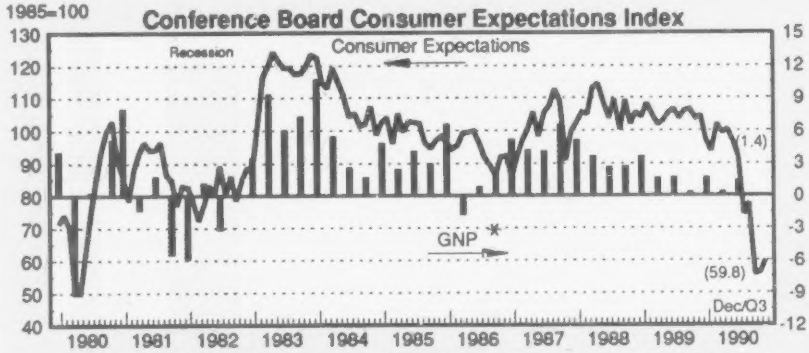
Data source: Morgan Stanley *Capital International Perspective*

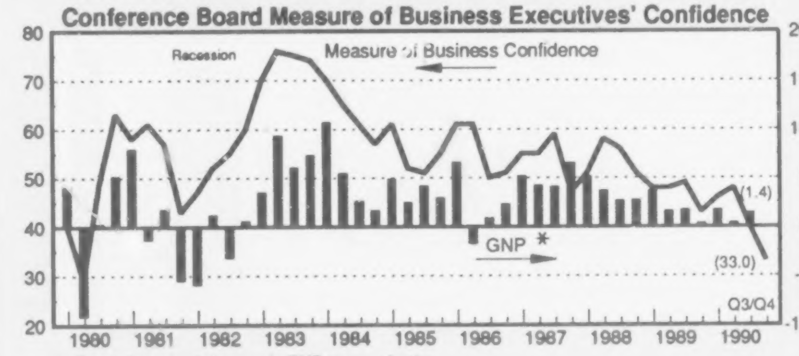
Bad Year For Equities. In 1990 prices fell in all of the world's ten largest stock markets. Japan had the worst plunge, down 40 percent, while the U.S. showed the smallest decline, 5 percent. Within the year, the pattern was quite similar in all countries, especially the sharp drop with the Gulf crisis. Recently, eight of the ten markets have shown some recovery, but in most cases not enough to encourage business-cycle forecasters.

Conference Board Stat File

If any doubt still exists about the extent of weakness in the economy, this month's Stat File should quickly dispell it. Every statistical series included here has either reached a level consistent with recession or is headed decisively in that direction. All a casual observor has to do is glance quickly at the two confidence measures, the help-wanted index, and the three diffusion indexes. The latter, which show how widespread the cyclical weakness has become, are the most compelling. The jury is still out on the length and severity of this business cycle — we are two months away from having the data necessary to reach an initial judgement on that question — but the recession-or-no question is no longer worth debate. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence

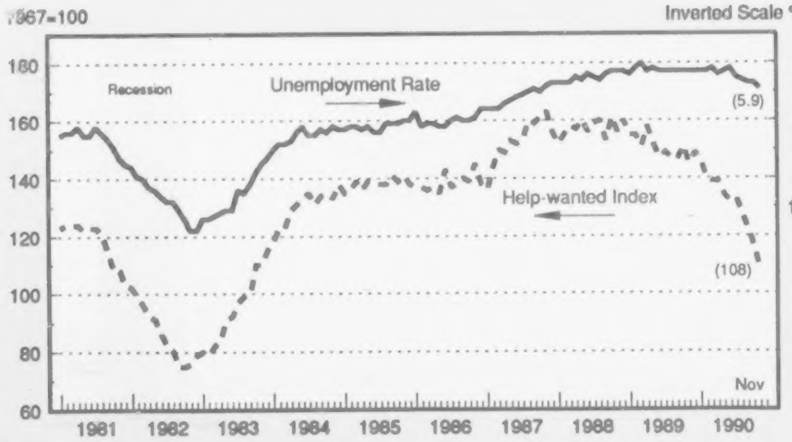




* Quarterly percent changes in GNP at annual rates

Very low readings.

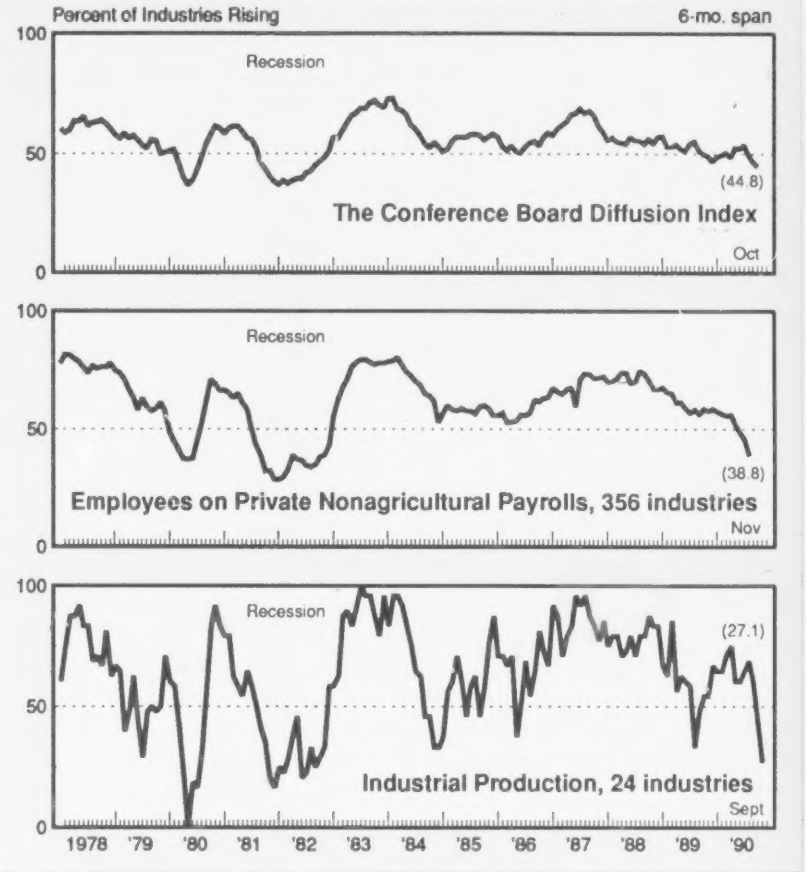
Help-wanted Advertising and Unemployment



Labor markets continue to sag.

Conference Board Stat File

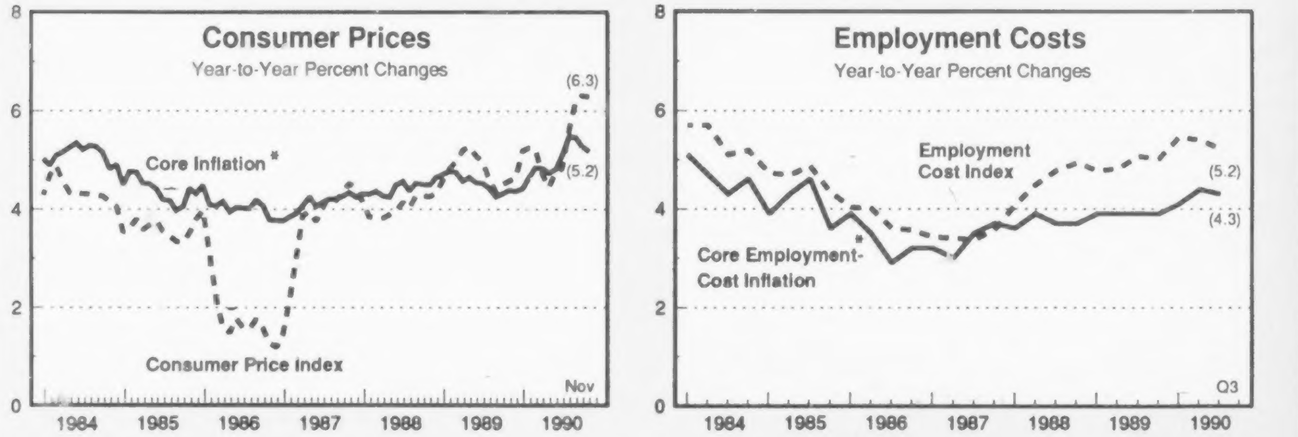
Indexes of Economic Momentum



Downturn spreading rapidly.

Core inflation is not following the surge in energy prices.

Inflation Fundamentals



* Core inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
		%	%	%	%	%	%	%	%		
Actual	1990 2Q	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q 1990	Actual
	3Q	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	3Q	
Forecast	4Q	-1.4	-3.0	-0.8	-2.1	-1.2	-2.4	-2.1	-1.6	4Q	Forecast
	1991 1Q	-1.6	-1.6	-2.1	-0.3	0.9	-2.6	-2.0	-0.6	1Q 1991	
	2Q	-1.6	0.4	-1.8	1.9	2.2	-1.2	-.3	1.3	2Q	
	3Q	1.9	2.2	1.5	2.0	1.4	2.1	2.4	3.3	3Q	
	4Q	3.6	2.7	2.5	1.6	2.0	2.9	3.3	3.2	4Q	
	1992 1Q	5.9	2.6	3.5	-0.2	2.3	3.4	4.9	2.4	1Q 1992	
	2Q	5.1		4.5	3.1	1.8	3.6	4.2	2.4	2Q	
	3Q	3.8		4.5	1.1	2.2	3.3	3.0	2.7	3Q	
	4Q	3.3		4.5	1.6	2.4	2.9	2.9	2.5	4Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

	UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA	
1990 4Q	4.8	4.4	4.7	4.8	4.8	4.6	4.1	4.5	1990 4Q
1991 4Q	4.0	4.3	4.6	4.4	4.6	3.3	3.3	3.9	1991 4Q
1992 4Q	2.8		4.0	4.7	4.6	2.3	2.9	3.6	1992 4Q

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Actual	1990 2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q 1990	Actual
	3Q	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	3Q	
Forecast	4Q	6.1	5.9	5.9	5.8	5.9	5.9	5.9	5.8	4Q	Forecast
	1991 1Q	6.7	6.3	6.4	6.0	6.0	6.4	6.4	6.4	1Q 1991	
	2Q	7.5	6.8	6.8	6.2	6.2	6.8	6.9	6.5	2Q	
	3Q	7.6	7.0	6.9	6.2	6.4	7.1	7.0	6.6	3Q	
	4Q	7.4	6.8	6.8	6.2	6.5	7.1	7.0	6.5	4Q	
	1992 1Q	6.9	6.6	6.7	6.3	6.5	7.0	6.8	6.5	1Q 1992	
	2Q	6.5		6.5	6.1	6.4	6.9	6.5	6.5	2Q	
	3Q	6.2		6.3	6.2	6.4	6.6	6.3	6.4	3Q	
	4Q	6.0		6.1	6.0	6.4	6.4	6.2	6.4	4Q	

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The Conference Board

Volume 2, Number 2 February 1991

Economic Times

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Serving Business and Society for 75 Years

Editor's Note

Economic policy advice is the main theme of this issue, starting on the next page with the views of our Colloquium on U.S. policies for dealing with the recession. Next you will find a compelling set of recommendations from a blue- ribbon panel of economists on how the U.S.S.R. should cope with its critical economic situation, which seems to grow more menacing every day, followed by a look at the impact of the policy regime put in place by Brazil's President Collor. The parallels between the U.S.S.R. and Brazil are especially interesting.

On other issues, our long-time colleague, Al Sommers, focuses his always perceptive eye at the automobile market from a not-so-usual angle. And then we tossed in a little piece called "Life Among the Econ," just for the pure fun of it.

Ed Fiedler

Pun of the Month:

How do you spot an old forecaster? Easy, they're long of sooth!

Rising Profits in Recession?

Those worrying that the 1990-91 recession will be long and deep focus heavily on the wide international scope of the current cyclical weakness and the likelihood that credit availability will be restricted because of the strained capital position of so many banks. On the other side, there are many analysts — a majority, by all reports — who expect a short, mild recession because the low dollar creates a highly advantageous competitive position for U.S. producers in world markets, and because the usual cyclical excesses and maladjustments that help bring on a recession — such excesses as a big inventory overhang — are absent.

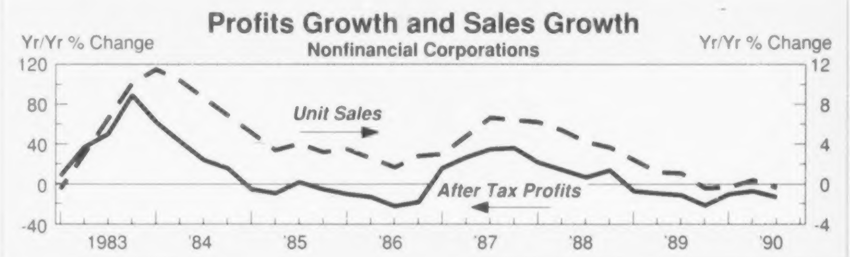
Another of the "usual suspects" conspicuous by its absence in the present situation is a difficult environment for profits. In most cycles, when the economy approaches a recession, costs begin to rise faster than prices and productive efficiency begins to deteriorate, both of which squeeze profits, which in turn feeds the recession by discouraging hiring plans and inducing cutbacks in capital expenditures.

In 1990, however, although productivity growth was held down by the slow growth in output, costs were otherwise kept under close control, so that — depending on which series you look at — profitability either improved slightly or softened slightly over the first three quarters of the year.

These auspicious indications about 1990 profits are being reaffirmed currently by the favorable expectations for 1991 so widely held by security analysts. The company-by-company forecasts of one well regarded Wall Street house show profits rising over 1990 in 42 of the 48 industries covered. Yes, that's right, the firm says we're in a recession, and yet the analysts are looking for profits to advance in an overwhelming majority of industries.

You're skeptical? You have every reason to be! In fact, don't believe it for a minute! Profits always drop during a recession, along with sales and all the other broad indicators of economic activity, both in the aggregate and across a majority of industries, usually a large majority. The chart below demonstrates the close relationship between profits growth and sales growth. The reasons are that when the economy declines, productivity also deteriorates, and price inflation slows faster than cost inflation. So profits drop sharply, and that will hold true in this recession, too.

Nevertheless, the optimism about 1991 profits that exists in Wall Street — and I believe also in the corporate boardrooms of America — is a strong signal that the economy entered this cyclical downturn without serious price-cost distortions and thus that profitability may well prove to be a less troublesome component of the current recession than is usually the case.



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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

Today's policymakers are operating in formidable times. By itself, the recession would be more than challenge enough. But in addition, the already dismal budget outlook is deteriorating rather than — as advertised after the painful fiasco last fall — improving. The Federal Reserve faces serious credit stresses throughout the financial system. And both must take account of the international turbulence in the Middle East, the U.S.S.R., GATT, and elsewhere.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

In your view, are the authorities pursuing appropriate monetary and fiscal policies? What changes, if any, do you recommend?

Don R. Conlan
Capital Strategy Research

Fiscal policy is rudderless so *che sera, sera*, depending on defense needs. Monetary policy is quite deflationary when adjusted for shifts in liquidity preference and credit turbulence. Renewed attention to the growth in monetary aggregates should have come earlier and probably would have without the jump in oil prices. But, hey, who am I to second-guess the Federal Reserve in this sea of uncertainty? It's the only functional economic policy weapon we have, but a patriot missile it ain't. War of any kind, including against inflation, is accident prone; so let's support the troops — there and here.

Laura D'Andrea Tyson
University of California, Berkeley

Recession, not inflation, is now the major enemy. Expansionary fiscal and monetary policies are proven weapons. The fiscal weapon is operating automatically as a result of countercyclical stabilizers. A war tax or any other deficit-cutting measure would offset these stabilizers, causing a self-inflicted wound. The monetary weapon is not automatic — it requires concerted action by the Fed to lower interest rates still further and to ease the credit crunch. Like the Allied command in the Gulf, economic policymakers must correctly identify the enemy and take coordinated action to defeat it.

Lyle E. Gramley
Mortgage Bankers Association

Sharp changes in macroeconomic policies are not the medicine needed to bring the economy out of recession. Thankfully, both the Administration and the Fed know that. The Fed has paved the way for a turnaround with gradual easing measures and encouragement to banks to lend more freely. Early termination of the Gulf war will bolster consumer confidence and keep oil prices down. The news on that front is promising; let's hope it stays that way.

Isabel V. Sawhill
The Urban Institute

I recommend a steady-as-we-go fiscal policy. Record-setting deficits of over $300 billion are inevitable this year given the weak economy, the S&L crisis, the war, and the removal of Social Security from the figures. But over the longer run deficits are headed down and Congress should resist the temptation to undo that progress by suspending the new budget rules in response to a flagging economy. A far better course, should the recession linger, is to ease monetary policy.

The Soviet Economic Crisis: Steps to Avert Collapse

The Soviet economy faces a worsening economic crisis that makes it essential immediately to:

1. Liberalize prices
2. Corporatize enterprise
3. Stabilize government spending and restrict credit
4. Moderate the social costs of unemployment, and
5. Open the economy to competition, both internally and internationally.

Liberalize prices. At present, prices remain controlled for more than 80 percent of total retail sales. To "liberalize" these prices means ending controls, allowing sellers to set prices that will cover their costs, without state subsidies. This will mean that goods will be available in the shops, which is not true currently.

The freeing of all retail and wholesale prices will lead to immediate price increases for most goods. Consumers will therefore face a reduction in their real wages, but they will also benefit from reduced time spent in lines, as the current system of rationing-by-queues requires. The ruble will buy less, but it will buy something. The price increases will bring goods from the back of the shop, where they are now sold illegally for high prices to a select few, to the front, available to all willing to pay the market-determined prices.

Price liberalization sets the stage for greater economic efficiency, by giving enterprises the incentive to serve the consumer. Competition will begin to develop, leading to improved efficiency, the only basis for improving the standard of living of the Soviet people.

Corporatize State Enterprises. Large enterprises must be converted into independent, self-financing, and profit-maximizing organizations. They must no longer be under the direction of the Ministries or dependent on the government budget for subsidies and investment funds. This step is distinct from privatization, which will require more time.

Directors of an enterprise must have the authority to set prices, output, and wages, as well as to determine inputs and financing. They must be free to enter whatever markets they wish to enter — except for such natural monopolies as the railroads and distribution of electricity, water and gas.

Self-financing or financial autonomy — a condition required to impose hard budget constraints on all large enterprises — means they can obtain money from only three sources: sales of their products, borrowing from banks, or sale of their assets. The enterprise must know that unprofitability ultimately means bankruptcy for the firm and economic ruin for the managers. The possibility of bankruptcy is the stick that makes enterprises efficient. The carrot is that successful enterprises retain a portion of their profits for bonuses to managers and to expand and improve their facilities.

In contrast to large state enterprises, retailing, services, and small-scale manufacturing can be privatized quickly by sale or leasing. All regulatory constraints on new entry into such markets should be abolished, except the minimum necessary to protect public health and safety (e.g., sanitary standards for restaurants and food stores).

Government Spending and Credit. The worsening inflation and hoarding must be restrained by reducing the budget deficit, tightening credit and liberalizing prices. In the budget we recommend focusing on spending reductions rather than tax increases, most importantly by removing subsidies to state enterprises. Automatic indexation for price increases should be minimized; perhaps the only exception would be for transfer payments to low-income households.

The Gosbank should extend credit only to firms that can repay it, and must place overall credit limits on the enterprise sector, much as western central banks do today. Real interest rates must be positive. The only certain way to check inflation is the threat of unemployment and bankruptcy that prevents firms from raising prices; for this, tight government budgets and credit policies are essential.

Opening the economy internationally will provide consumer goods, speed the introduction of foreign technology, ensure that prices reflect competitive world market prices, and restrain monopolistic forces inside the Soviet Union.

Dealing with Unemployment. The steps recommended here will inevitably mean unemployment for large numbers of workers. Economic progress is impossible if every worker is guaranteed his or her job in its present location. Unemployment compensation is the only way to prevent severe hardship for workers in the transition. The level of compensation, however, must be substantially below the wages of those who continue to work and should decrease with the length of unemployment, in order to preserve incentives for workers to relocate, retrain and accept alternative employment.

Open the Economy Internationally. In addition to creating an open, competitive market economy **within** the Soviet

Union, as the recommendations we have made to this point would do, opening the economy internationally can play a critical role. We recommend moving to a convertible currency and removing import and export restrictions very quickly. Opening the economy will provide consumer goods, speed the introduction of foreign technology, ensure that prices reflect competitive world market prices, and restrain monopolistic forces inside the Soviet Union.

Conclusion. We recognize that these proposals will be painful and controversial. They impose major social costs in the short run as the Soviet society makes the transition from a centralized administrative approach to the decentralized direction of individuals through markets. Moreover, it is not possible to provide an ironclad guarantee that these measures will cure the nation's ailments. But history shows again and again that allowing markets to direct an economy offers the best hope for resuscitating the sick economy and for raising living standards toward those in Western Europe and the United States.

Excerpted from a memorandum prepared at the request of Stanislav S. Shatalin, a leading economic adviser in the U.S.S.R. and main author of the 500-day plan to move the Soviet economy quickly toward a market system — the plan rejected by the Soviet Parliament. The November 1990 memorandum — thus far not published in the U.S.S.R. — was the product of a distinguished panel chaired by Merton J. Peck (Yale), and including Wil Albeda (MERIT, Netherlands), Barry Bosworth (Brookings), Richard Cooper (Harvard), Alfred Kahn (Cornell), William Nordhaus (Yale), Thomas Richardson (Yale) and Kimio Uno (Keio University, Japan). ■

The Brazilian Economy — The Recession is Not the Worst

by Geraldo Hess

The most serious aspect of the present economic crisis in Brazil is that business executives are losing sight of what is behind President Collor's plan. Those who think the recession is the major problem start from the premise that the principal objective of the Collor Plan is to destroy inflation, and that once the inflationary battle is won the Brazilian economy is going to continue as before.

Nothing could be more wrong. The principal goal of the plan is to provoke a real opening of the country to external competition. If that goal is achieved and inflation is overcome, Brazil is going to be very different than it was.

Previously, Brazil was a place where markets were reserved for companies doing business here. Brazilian companies only had to compete internally; the true competitors, external products, were out of play. As a result, Brazilian executives were preoccupied with making the product. Little attention was given to quality and service. And they could achieve high profit margins.

Now, if the economy is really opened, executives will have to adopt a broader, longer term vision. Product quality will become more important. Service will have to be part of the business. Profit margins will be much thinner. And it will no longer be possible to produce only what the company knows, but rather what the customers want. Consequently, despite all the difficulties, Brazilian companies will have to become truly efficient in order to compete.

Otherwise, all that will remain is to pray that the external attack will be delayed, and to continue business as usual while failing. After all, even death is only a question of time.

(Note: As of early January, the issues discussed here have become partly outdated. Inflation is again — at least for now — the major concern, and prospects for success of the full plan are highly questionable.)

Geraldo Hess is a Brazilian business consultant, and member of the Board of Directors of fourteen business groups. An earlier version of this commentary was published in the magazine, Amana.

Quotable Quote

The "Money Belt" Recession *by Edward J. Campbell*

The current recession did not start in the "farm belt," the "rust belt" or the "energy belt." This is a "money belt" recession, where both individuals and institutions have taken in their belts a notch. Individuals have tightened their spending belts because of reduced real incomes and uncertainties about the Middle East. And the banks have tightened their lending belts because of tougher standards imposed upon them by the regulators. These two constraints, together, were the progenitors of the 1990-91 recession.

Edward J. Campbell is Chief Economist, Brown Brothers Harriman & Co.

Life Among the Econ

by Dr. Axel Leijonhufvud, University of California at Los Angeles

The Econ tribe occupies a vast territory in the far North, bleak and dismal. Traveling through it makes for rough sledding. The Econ are not without some genuine attachment to their ancestral grounds, however, and their young are brought up to feel contempt for the softer living in the warmer lands of their neighbors, the Polscis and the Sociogs.

For such a primitive people, the social structure is quite complex. An extremely interesting aspect of status among the Econ is that status relationships do not seem to form a simple hierarchical "pecking-order," as one is used to expect. Thus, for example, one may find that A pecks B, B pecks C, and then C pecks A! This non-transitivity of status may account for the continual strife among the Econ, who are known widely as the "quarrelsome race." Social cohesion is apparently maintained chiefly through shared distrust of outsiders.

The dominant feature among the Econ is the way that status is tied to the manufacture of certain types of implements, called "modls." The facts (a) that the Econ are highly status-motivated, (b) that status is only to be achieved by making "modls," and (c) that most of these "modls" seem to be of little or no practical use, probably accounts for the backwardness and abject cultural poverty of the tribe.

The rise of certain groups within the tribe seems to be associated with the trend among all the Econ towards more ornate, ceremonial modls, while the low rank of others is due to the fact that, in recent times, they have not strictly enforced the taboos against association with the Polscis and Sociogs. The elite Econ look upon this with considerable apprehension as endangering the moral fiber of the tribe.

The Econ and the Future. The prospect for the Econ is bleak. They are poor — except for a tiny minority, miserably poor. In their poverty, they are not even saved from the problems of richer nations — travellers tell of villages half-buried in the refuse of unchecked modl-making. Even their famous Well Springs of Inspiration are now polluted.

Econ political organization is weakening. The power of the elders has been eroding for some time. Respect for one's elders is no more the fashion among the young Econ than among young people anywhere else. Recognized status has come increasingly to be tied to cleverness in modl-making.

Under circumstances such as these, we expect alienation, disorientation, and a general loss of spiritual values. And this is what we find. A typical phenomenon indicative of the break-up of a culture is the loss of a sense of history and growing disrespect for tradition. Contrary to the normal case in primitive societies, the Econ priesthood does not maintain and teach the history of the tribe. In some Econ villages, one can still find the occasional elder who takes care of the modls made by some long-gone hero of the tribe and is eager to tell the legends associated with each. But few of the adults or grads, noting what they regard as the crude workmanship of these dusty old relics, care to listen to such rambling fairytales. Among the younger generations, it is now rare to find an individual with any conception of the history of the Econ. Having lost their past, the Econ are without confidence in the present and without purpose and direction for the future.

Excerpted from Axel Leijonhufvud, *Information and Coordination*, Oxford University Press, 1981, New York and Oxford.

Albert T. Sommers' Statistical Insight

Automobiles-Growth With Vigorous Maybe Violent Competition

Albert T. Sommers
Senior Fellow and
Economic Counsellor
The Conference Board

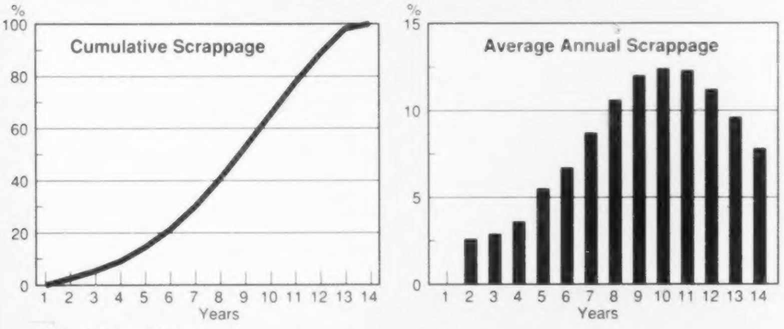
The automobile holds a distinctive place in the American economy and its culture, and in the dreams and aspirations of Americans. A nearly unique American combination of upward social mobility, large distances, cheap gasoline and mechanical inventiveness long ago identified the automobile with American society far more intimately than elsewhere. As a result, for large parts of the 20th Century the U.S. economy went the way of the automobile market; in the later 1920's, in fact, an officially recognized "recession" was produced by a several months model change-over at Ford.

All of the postwar recessions were characterized by a depressed auto market. Now comes 1991, and recession has already made its mark in sharp curtailment of auto production schedules. Where is this major industry headed?

From the point of view of the aggregate system, a number of variables come into play that regulate the course of auto sales. Of these, the scrappage rate of automobiles is probably the most important. The figures on scrappage are a little esoteric, and not frequently reported; they are nevertheless very useful in getting a loose fix on the future of the market, because the scrappage cycle for an automotive model year is surprisingly constant across model years. It is therefore feasible to construct an average or theoretical scrappage cycle; and because the scrappage rate is very low in the early life of a model, aggregate scrappage turns out to be reasonably predictable for several years beyond the end of the actual data on scrappage. *At least the replacement market for automobiles in the near future can be known.*

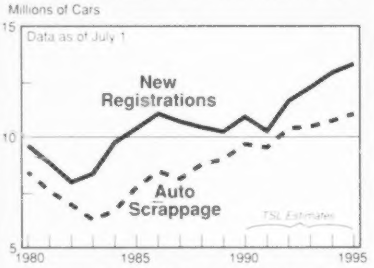
The chart below shows the accumulation of the scrappage against a year's automotive production; by thirteen years out practically all the production is off the road. The right-hand panel shows the percentage of the output scrapped each year, indicating a peak scrappage rate of 12 or 13 percent of the production around the tenth and eleventh year. Finally, the second chart shows the actual scrappage over the past decade, and projected scrappage to 1995; the estimates rest a little on assumed production to 1995, but the probable error is small, since scrappage in the early years of the model is low. Shown with the scrappage line are the actual annual registrations of new automobiles; the projections to 1995 rest partly on expected household formation, and intuition about the short-term economic outlook. The gap between the two lines is, of course, the net change in the stock of automobiles on the road. On average something like 85 percent of automobile production is simply to replace scrapped vehicles, and only 15 percent for growth of the market itself.

The Life of A Model-Year's Output



Note: All data as of July 1
Sources: Ward's Automotive Reports; R.L. Polk and Company; The Sommers Letter

The Future of the Market



Sources: Ward's Automotive Reports; R.L. Polk and Company; The Sommers Letter

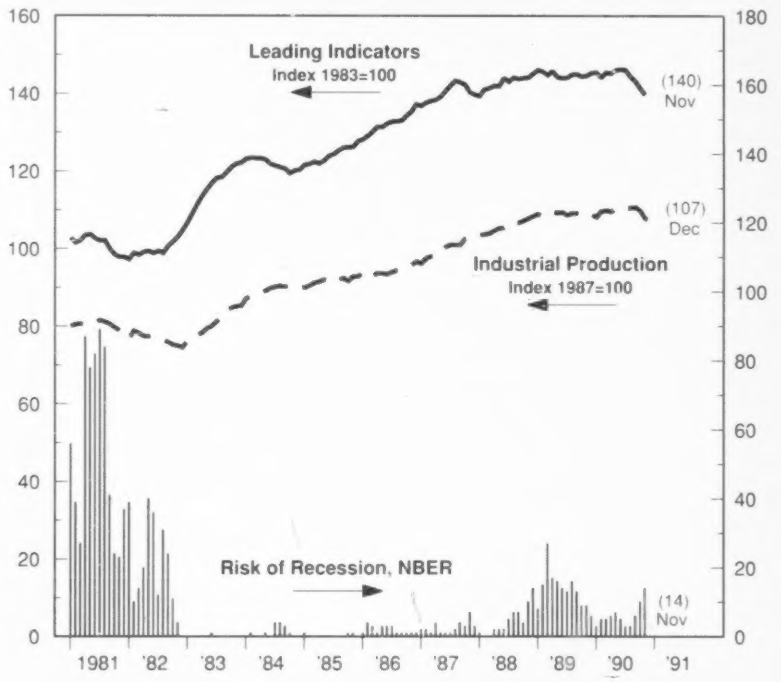
The implications of these figures are that the U.S. automobile market still has a lot of room to grow after recession is over; the growth rate will depend upon the growth of incomes, consumer confidence, prices, and the increase in the number of U.S. households.

While the market will gradually get bigger in the future, its growth rate does not look dramatic, particularly in the light of the growth rate of output of the so called "transplants" — foreign automobile companies producing in the United States. For the early 1990's, what all of these abstruse calculations suggest is that the automobile industry in the United States has opportunities for moderate growth over the next half-dozen years, as ownership and scrappage rise, but that the market will be vigorously, maybe even violently, competitive.

Conference Board Stat File

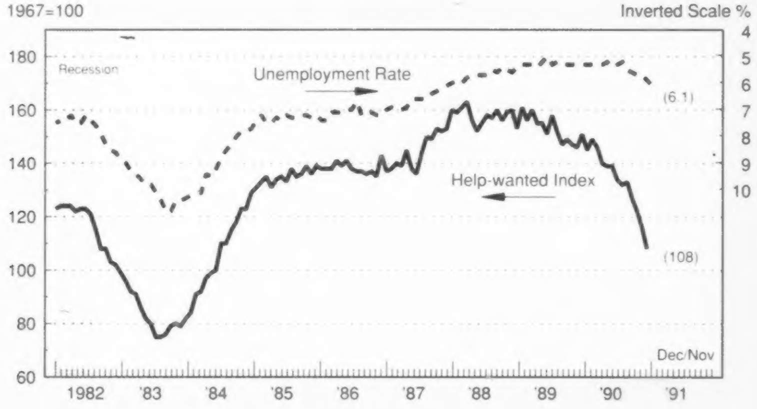
Data in the Stat File this month fully reaffirm that the economy is in the recession stage of the business cycle. The question turns, then, to the possibility of an early recovery. For now, the only indicator pointing in that direction — not to be dismissed but less than persuasive by itself — is the 3 month upswing in stock prices. Otherwise the present cycle looks very typical of the post-World War II experience, with no significant sign of either a shorter and milder recession or one longer and steeper than the normal range. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence



Leaders and production show typical recession dive; NBER calculation shows a curiously modest "risk"!

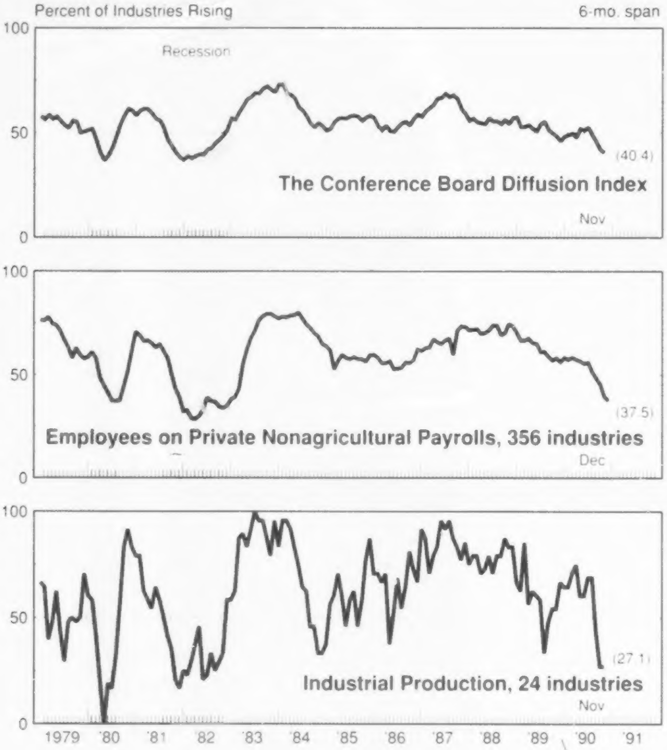
Help-wanted Advertising and Unemployment



Labor markets continue to show weakness.

Conference Board Stat File

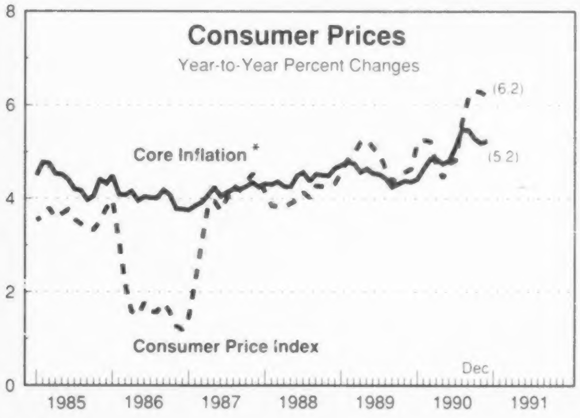
Indexes of Economic Momentum



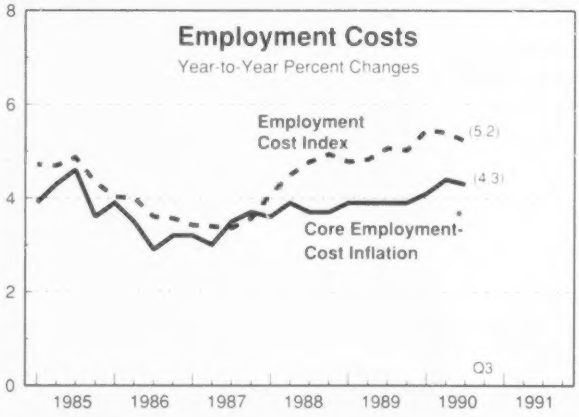
Downturn widespread, typical of recession.

Core inflation steady in recent months; recession impact, if any, still to be seen.

Inflation Fundamentals



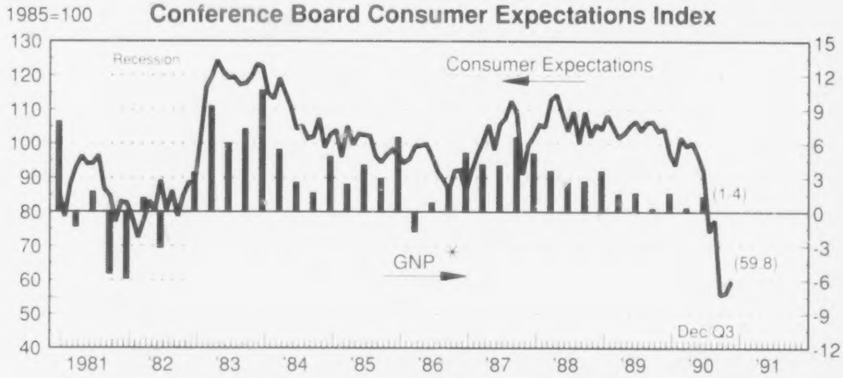
* Core Inflation = CPI excluding food at home and energy.



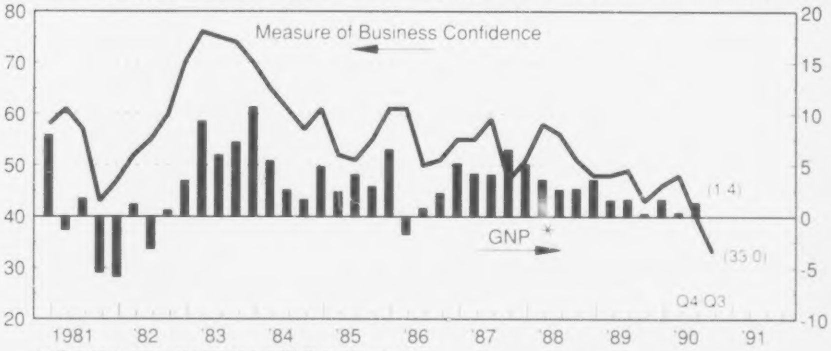
* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

Conference Board Stat File

Confidence



Conference Board Consumer Expectations Index

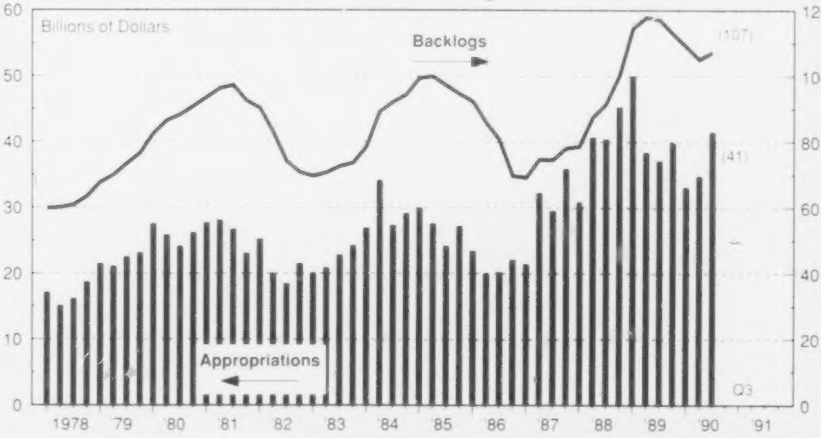


Conference Board Measure of Business Executives' Confidence

* Quarterly percent changes in GNP at annual rates

Confidence remains very low.

Investment Intentions



Conference Board Capital Appropriations Manufacturing

Third-quarter appropriations surprisingly robust.

Inside the Crystal Ball

	UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA
Date of Forecast	Jan.	Jan.	Jan.	Jan.	Jan.	Jan.	Jan.	Jan.

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		%	%	%	%	%	%	%	%		
Actual	1990 2Q	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q 1990	Actual
	3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q	
Forecast	4Q	-2.1	-3.5	-2.1	-3.9	-1.9	-3.3	-3.0	-2.3	4Q	Forecast
	1991 1Q	-2.9	-1.6	-1.8	-2.8	0.7	-2.1	-2.1	-0.9	1Q 1991	
	2Q	-2.1	-2.5	-1.2	-0.2	1.5	-1.1	-0.4	2.3	2Q	
	3Q	0.8	0.4	2.0	1.1	1.1	2.4	3.0	4.1	3Q	
	4Q	5.3	3.1	2.7	1.2	1.7	2.9	3.6	3.3	4Q	
	1992 1Q	7.8	3.0	3.5	0.8	2.3	3.2	4.6	2.6	1Q 1992	
	2Q	4.7		4.5	3.0	1.8	3.8	4.3	2.3	2Q	
	3Q	3.9		4.5	2.5	2.2	3.2	3.1	2.7	3Q	
	4Q	2.9		4.5	2.8	2.4	2.9	3.0	6	4Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

1990 4Q	4.5	4.5	4.7	4.6	4.7	4.6	4.1	4.3	1990 4Q
1991 4Q	3.7	4.1	4.6	3.3	4.6	3.1	3.1	2.9	1991 4Q
1992 4Q	2.6		4.0	4.3	4.6	2.2	2.9	3.3	1992 4Q

Unemployment Rate

(Percent, quarterly)

Actual	1990 2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q 1990	Actual
	3Q	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	3Q	
Forecast	4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q	Forecast
	1991 1Q	6.7	6.5	6.4	6.2	6.3	6.3	6.6	6.4	1Q 1991	
	2Q	7.2	7.0	6.8	6.6	6.5	6.8	7.1	6.5	2Q	
	3Q	7.4	7.1	6.9	6.6	6.6	7.0	7.1	6.5	3Q	
	4Q	7.1	6.9	6.8	6.8	6.6	7.0	7.1	6.4	4Q	
	1992 1Q	6.5	6.6	6.7	6.9	6.5	7.0	6.8	6.4	1Q 1992	
	2Q	6.2		6.5	6.7	6.4	6.8	6.6	6.3	2Q	
	3Q	5.9		6.3	6.4	6.4	6.6	6.4	6.3	3Q	
	4Q	5.8		6.1	6.0	6.4	6.4	6.2	6.2	4Q	

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845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
and at
additional mailing offices

Statistical Reference Index
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4520 East West Highway
Suite 800
Bethesda, MD 20814

R4105-80

The Conference Board

Volume 2, Number 3 March 1991

Economic Times

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Serving Business and Society for 75 Years

Editor's Note

This month we hear from those long and widely celebrated mavens of the money markets, Dr. Doom and Dr. Gloom, by proper name Al Wojnilower and Henry Kaufman. (Were they Gloom and Doom, respectively? Or Doom and Gloom? I can never remember, but that's OK because the appellations weren't really appropriate anyway.) Al's piece, which you'll find on the shaded paper in the center is one of those thorough, impeccably logical analyses for which he is renowned. Henry's provides some brief but incisive insights on our faculty for forecasting.

Rudy Penner, another unusually perceptive analyst, explains why those who would escalate the U.S.-Japan marital spat over trade into a martial conflict ought to cool it instead. And our Colloquium panel tells us how the early end to the Gulf War changes their economic outlook.

Ed Fiedler

Cynicism of the Month:

The President and Congress haven't closed the budget gap with a value added tax because the Democrats worry that it's regressive and the Republicans worry that it's such a potent money machine. A VAT *will* be adopted as soon as the Republicans recognize it's regressive and the Democrats recognize it's such a potent money machine!

And You Takes Your Choice

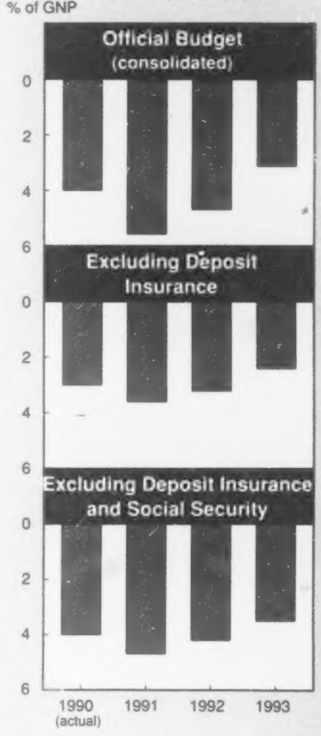
There have always been different ways to look at the budget deficit, and this year the choice is wider than ever. Three popular options are shown in the chart below. The first is the official "consolidated" budget, usually a good way to view the budget, but less so now. The second excludes the amounts associated with the savings-and-loan bailout — excluded on grounds that to borrow these funds from one part of the financial system and then pay them out to another is merely a balance-sheet transaction that won't impact significantly on interest rates or the general economy. The third version also excludes the outlays and revenues of social security, medicare, and so forth, on grounds that the surpluses generated there should be accumulated to finance the extra bulge of benefits needed for retirees of the mid-21st century and thus should not be used to finance spending in the 1990s.

Which of these projections is "best?" It depends on the purpose. If you are concerned about how the budget is going to impact the economy near term, we suggest the second version. Alternatively, if what interests you is to what extent spending will have to be curbed and/or revenues increased to balance the budget *and* meet the extra needs of 21st-century retirees, then use the third version.

But if you are looking for a realistic forecast, don't depend on any of these projections, especially for the "out years." No, it's not that the politicians are playing games with the budget numbers — there's much less "blue smoke and mirrors" than in the past. The problem, now as always, is that the budget projections are based on the assumption that no additional spending programs or tax changes will appear in the years ahead. That's a necessary assumption, but it doesn't make for realistic budget forecasts. Remember Fiedler's Law (#367), "All budget surprises raise the deficit." (Well, almost all.) So raise those out-year projections. How much? Sorry, you're on your own. Or as the carnival barker says, "You pays your money and you takes your choice."

This much we will venture: 2-3 years ahead the deficit is likely to fall substantially from its present 4-5 percent or so of GNP. But it'll take a lot of luck to get below 2 percent again. And even 2 percent is a *big* deficit.

Budget Deficit Projections
Take Your Pick!



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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

In the Gulf, the early action in the ground war suggests a quick and decisive Allied sweep. And the Iraqis are at least **talking** *about withdrawing. Thus prospects for an early victory by the Coalition forces are favorable.*

Question:

If the war does wind down to a successful conclusion soon, how will that change your view of the economic outlook?

Stephen H. Axilrod
Nikko Securities International

A successful conclusion of the war would change my view of the economic outlook only a little. There may be a pick-up in confidence that spurs some consumer spending. And oil prices and inflationary pressures will be lower than if the war persisted. But given various structural problems in the economy and the strong likelihood that a 1980s type consumer boom will not be repeated, the economic recovery is still likely to be more sluggish than the norm.

John T. Dunlop
Harvard University

Consumers are bunkered down. Governments are in deficit everywhere and squeezing for higher taxes (fees). Real incomes are down; automatic stabilizers are in poor shape. Housing and real estate are comatose, and gun-shy bankers are unwilling to accept an active expansion role despite Fed action. There is no leading region. Lower oil prices and exports may help, but the international world is seeking capital to rebuild and modernize. The year 1991 is shot.

Charles L. Schultze
The Brookings Institution

A long war would imply enough success on Saddam Hussein's part in giving the United States a black eye that, even if ultimately defeated, he could become a focus for instability in the Middle East. The long-term economic consequences, by way of potential large instability in oil prices and supply, could be very serious. A short war would thus be good for the long-term economic outlook.

Charls E. Walker
Charls E. Walker Associates

Claims to the contrary notwithstanding, Hussein's invasion of Kuwait did **not** cause the recession, nor will an early and favorable conclusion to the war end it. The U.S. today is paying for the fiscal sins of the 1980s. Since a major result of those sins is minimum "wiggle room" for anti-recessionary fiscal and monetary policies, the only choice now is — regrettably — to hunker down and hope for the best.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Japan and the United States: Can this Marriage be Saved?

by Rudolph G. Penner

Some Americans seem to need a new enemy to replace the Soviet Union, and some Japanese seem willing to oblige.

Now that communism is crumbling, some Americans seem to need a new enemy to replace the Soviet Union, and some Japanese seem willing to oblige. To these Americans, Japan seems a workaholic, unscrupulous trader bent on world economic domination. And to those Japanese, the United States seems a nation in relative decline filled with lazy, shortsighted overconsumers.

All this may seem like mindless emotionalism and it is. But it is beginning to permeate the intellectual and business leadership of both countries, fueling support for trade restrictions and retaliation. That makes it dangerous.

The Facts. The facts are not disputed even by the most virulent protectionists on both sides of the dispute:

- Even if Japan removed every protectionist element in its system the American bilateral trade deficit with Japan would be little affected.
- Japanese imports have widened U.S. consumers' choices and enhanced our living standards.
- Americans need Japanese capital to make up for our paltry savings rate. Without Japanese capital, American interest rates would be higher.
- The Japanese profit from both the openess of American markets and a safe, profitable haven for their excess savings.
- Most Japanese would benefit if their own markets were as open as ours.

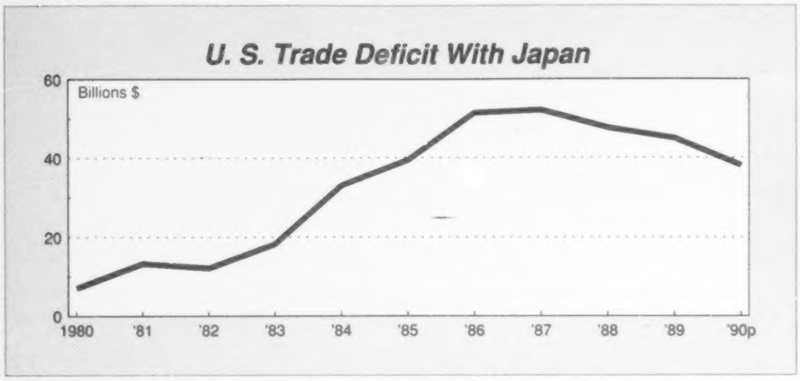
Obstacles. One would think that since such facts are not in dispute it should be easy to reduce tensions. But three major problems stand in the way.

First, Japanese protectionism is implicit. It stems from long established anti-competitive ties among Japanese businesses and government regulation. Even if the Japanese government honestly promises to reduce barriers, the promises are often worthless without the cooperation of Japanese bureaucrats and private decision makers.

Second, the U.S. Congress created a monster when it passed the Trade Act of 1986. The Act requires few substantive actions, but it requires reports on the sins of other nations. The "super 301" provision, for example, requires the Administration to name "priority" countries whose protectionism significantly affects U.S. exports. This might not be so bad if the United States were free of sin, but given our many protectionist measures it is downright sanctimonious. Worse, it deprives our international negotiators of an essential negotiating tool — subtlety in bargaining — while providing protectionists with an excuse to be self-destructive. The Administration is courageously refusing to label Japan a sinner this year because of progress in recent trade talks. The Congressional criticism of this move cannot help relations between the two countries.

Third, many noneconomists erroneously view trade as a battle in which you cannot win unless someone else loses--somewhat like competing in the Olympics. In such a frame of mind the nation can be seduced into taking great pleasure in expanding its market at the expense of its competitor's market share, even though "victory" may be economically costly. And people become morally outraged if competitors violate the rules of the game, even if the violations have little effect on the final outcome.

Our Economic Self-Interest. Nevertheless, when trade conflicts emerge the



general public occasionally shows that it can understand the theory of free trade quickly when economic self-interest comes into play. Here's an example: A TV reporter interviewed a woman buying clothes in a discount store. He pointed out that all the clothes were made in Asian countries. He further suggested that foreigners could compete unfairly by using cheap labor, and that such products should be banned. The woman agreed and became an instant protectionist. He then pointed out that the prices of such products would probably rise 20 percent in the absence of imports. "Well then I'd better rethink my position," said the woman. The instant protectionist was transformed into an instant free trader. This example illustrates an intuitive understanding of the basic principles of free trade:

- Importing goods increases competition, lowers prices, and so enhances our living standards.
- Importing capital allows our investment levels to exceed domestic savings, and so increases the productivity and real wages of our workers.

It would, of course, be foolish to argue that imports of goods and capital never cause problems, especially for particular industries. It is not surprising that the losers seek protection. Free markets are not painless, but as recent events in socialist countries illustrate, other systems are a good deal worse.

The Debate. The basic lesson emerging from international trade theory is that, with rare exceptions, it is in the selfish interest of a country to remove trade barriers even if other countries do not. Although many understand this lesson intuitively, it can be difficult to sell to non-economists as an intellectual proposition. Two questions bedevil the debate. **If free trade is so wonderful, why can't you convince the Japanese?** The answer to this one is that the Japanese have, in fact, been slowly freeing up their economy.

> *The general public occasionally shows it can understand the theory of free trade quickly when economic self-interest comes into play.*

If protection is so destructive, how have the Japanese been so successful? There is no contradiction between Japanese protectionism and their extraordinary growth performance. Protection may be costly, but it does not necessarily overwhelm other sources of growth. It must be remembered that the Japanese started from a very low level after World War II and they still are a long way from catching up. That in no way detracts from their great skill and extremely hard work, but one cannot help but wonder how long the miracle will last if they do not apply their own dose of perestroika.

Best Strategy. The first step for both countries is to avoid making false promises, which can only set back the cause of free trade further. The second is to continue to negotiate and press for concessions in return for making more of our own. Economic theory may teach us that Japanese protectionism is more their problem than ours, but in the current state of tensions that argument will not persuade Americans to accept Japanese trade restrictions or to lower our own trade barriers unilaterally.

> *"Marriage has many pains, but celibacy has no pleasures."*

The most important theme motivating negotiations should be the constant reminder that the United States and Japan need each other. Both have benefited greatly from their cooperative relationship since World War II. Both face the challenges of radical developments in Eastern Europe and further economic integration of Europe in 1992. There are enormous potential gains to Japan and the United States from ensuring that the two developments are fully integrated into an efficient, freely functioning international economy.

Those who demand a more confrontational approach to Japan should think through the implications of an all-out trade war. Suppose the United States retaliates against Japanese imports and Japan counters with restrictions on Japanese investment in the United States. The potential disruption could be disastrous.

It is time to cool the emotions and dampen the rhetoric. We really do need each other. In the words of Dr. Johnson, "Marriage has many pains, but celibacy has no pleasures."

Excerpted from the June 1990 issue of *Policy Bites*, a bi-monthly commentary from the Urban Institute.

On Foreseeing the Unforeseeable

By Henry Kaufman

In making economic judgments, the future is very often projected to be an extension of the recent past. But these surprise-free scenarios simultaneously oversimplify the complexities of economic life and obscure important trends and changes that influence the longer term.

Projecting the future as an extension of the recent past oversimplifies the complexities of economic life and obscures important trends.

To illustrate the problem of perceiving fundamental or longer lasting change, I want to examine a few pages from history. Could a reasonable person, armed with today's analytical skills, have been expected to foresee the changes that took place?

At the dawn of history, life was dominated by huge dinosaurs, fifty-foot crocodiles; the sea swarmed with twenty-foot lizards. The mammals, small and shrew-like, hid in the thickets and grasses during the day and ventured out only at twilight or in the dark. Undoubtedly, a modern-day rating agency would have accorded the dinosaurs the highest credit rating and given no rating at all to the frightened mammals. Today, of course, the dinosaurs are extinct and mammals are the dominant life form.

Undoubtedly, a modern-day rating agency would have accorded the dinosaurs the highest credit rating.

How many living in biblical times were able to perceive the far-reaching impact that the Ten Commandments would have on the morality and behavior standards of much of mankind?

Perhaps these illustrations are too remote. More recently, then, how many people living in the nineteenth century would have made a correct judgment about the rise of the United States to world leadership? Textbooks often describe nineteenth-century America as a succession of excesses and calamities. The economy is pictured in terms of wild speculation, knavery, and irresponsible finance. In one panic, fourteen railroads went into bankruptcy, and in another, 600 banks failed. Nevertheless, it was during this century that the West was settled and developed, massive railroad constructions took place, prosperity was occasionally spectacular, and the United States began to blossom into an industrial giant.

At the close of World War II in 1945 how predictable was the spectacular recovery staged by Germany and Japan? Or the rapid growth of multinational corporations and the development of international financial networks?

There is simply no scientific procedure that yields accurate economic judgments about the long term. Yet, if we are to make economic progress, we must persist in this effort.

These remarks by Henry Kaufman, president of Henry Kaufman & Co., a money management firm, are excerpted from his commencement address at the Columbia Business School, May 1990.

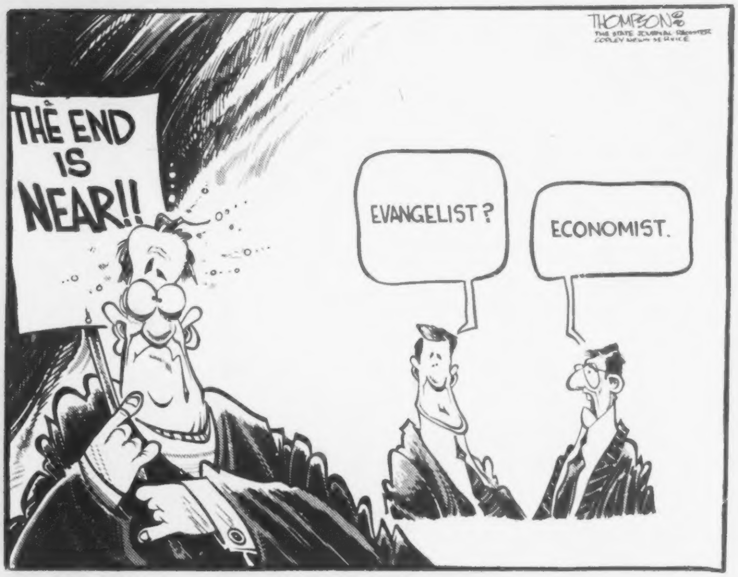
Quotable Quote

by Virgilio Barco, President of the Republic of Columbia

Just as history will recall the 1980s as an era when democratic forces swept the globe, it will also be remembered as a decade of resurgence in free market economics. This is a revolution of enormous significance, a recognition of our global economy, and a confirmation that open economies with access to markets can lead to social progress. It seems that the long-running match between Karl Marx and Adam Smith is finally coming to an end. I applaud this development, but at the risk of sounding passe, let me issue a warning.

In our rush to embrace free market forces, let us not lose sight of the fundamental role of government, as it embodies the free and collective will of its people. There is a role for both market forces and the state in solving social problems. Free market policies should not be used as an excuse for the lack of political will, whether it is assuring justice and fighting drug trafficking or providing basic education and health care. Free market economics is not a magic wand which somehow will relieve us of the obligation to care for our fellow human beings.

Excerpt from President Barco's commencement address at the Massachusetts Institute of Technology, June 1990.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EVANGELIST?
ECONOMIST.

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On an ordinary day in the United States:

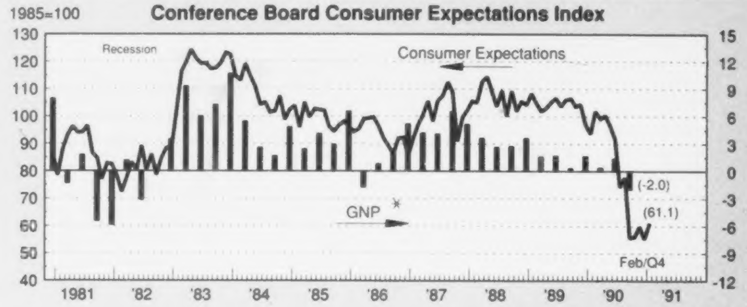
- Americans take 80 million aspirin tablets.
- 2 million is spent on exercise equipment and $3.5 million on tortilla chips.
- Four people call Graceland and ask to speak to Elvis.

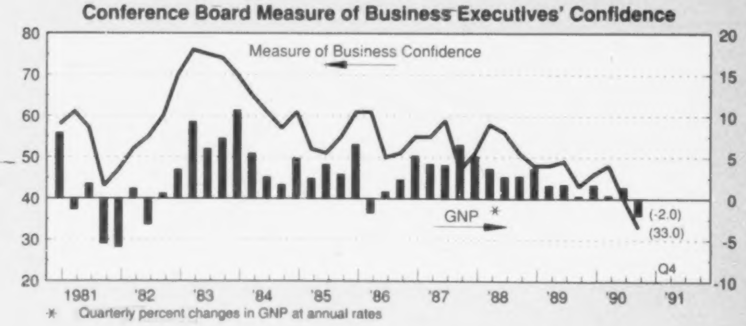
(from Stamats Communications "Newsletter")

Conference Board Stat File

Just as the Gulf War proceeded on schedule, so does the recession. Most of the recently reported statistics, including, for example, The Conference Board's help-wanted advertising index below, show the downswing continuing apace. Here and there some modest encouragement appears: The consumer expectations index below and the diffusion indexes on the next page have stopped falling. And stock prices advanced sharply again in February. These favorable signs, however, are not yet sufficiently widespread to be read as harbingers of an early upturn. From here, the best bet still calls for the cyclical downswing to continue until the middle months of the year. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence

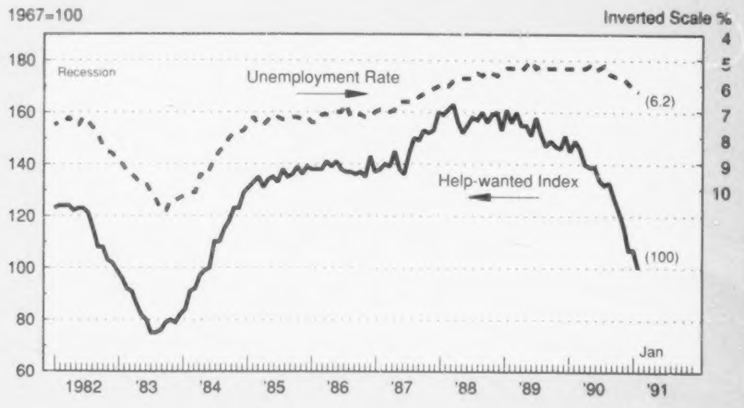




* Quarterly percent changes in GNP at annual rates

No Decisive signal of a recovery in confidence can be seen yet.

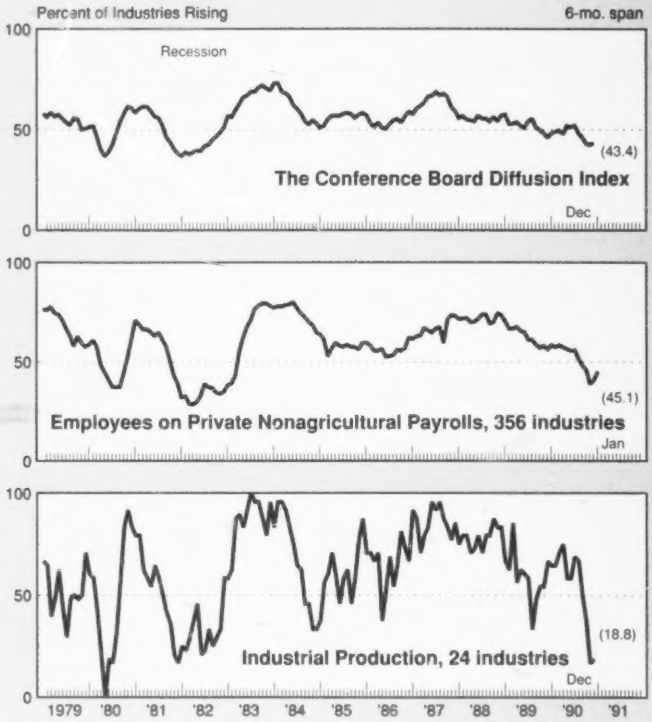
Help-wanted Advertising and Unemployment



Labor markets still weakening.

Conference Board Stat File

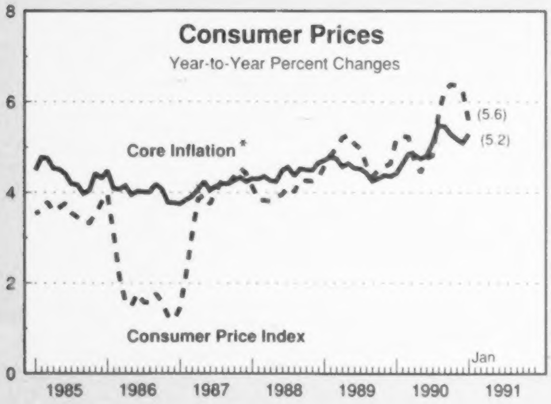
Indexes of Economic Momentum



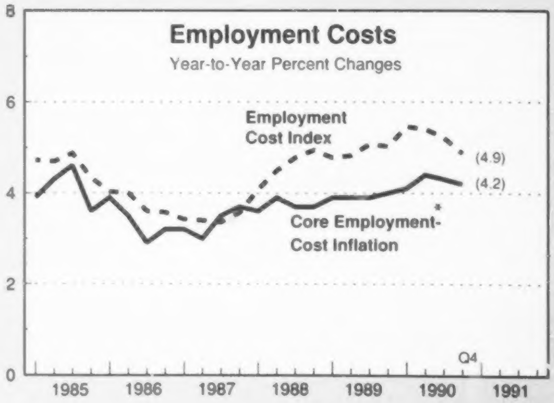
First hints seen of the bottoming in cyclical momentum.

Inflation momentum persists.

Inflation Fundamentals

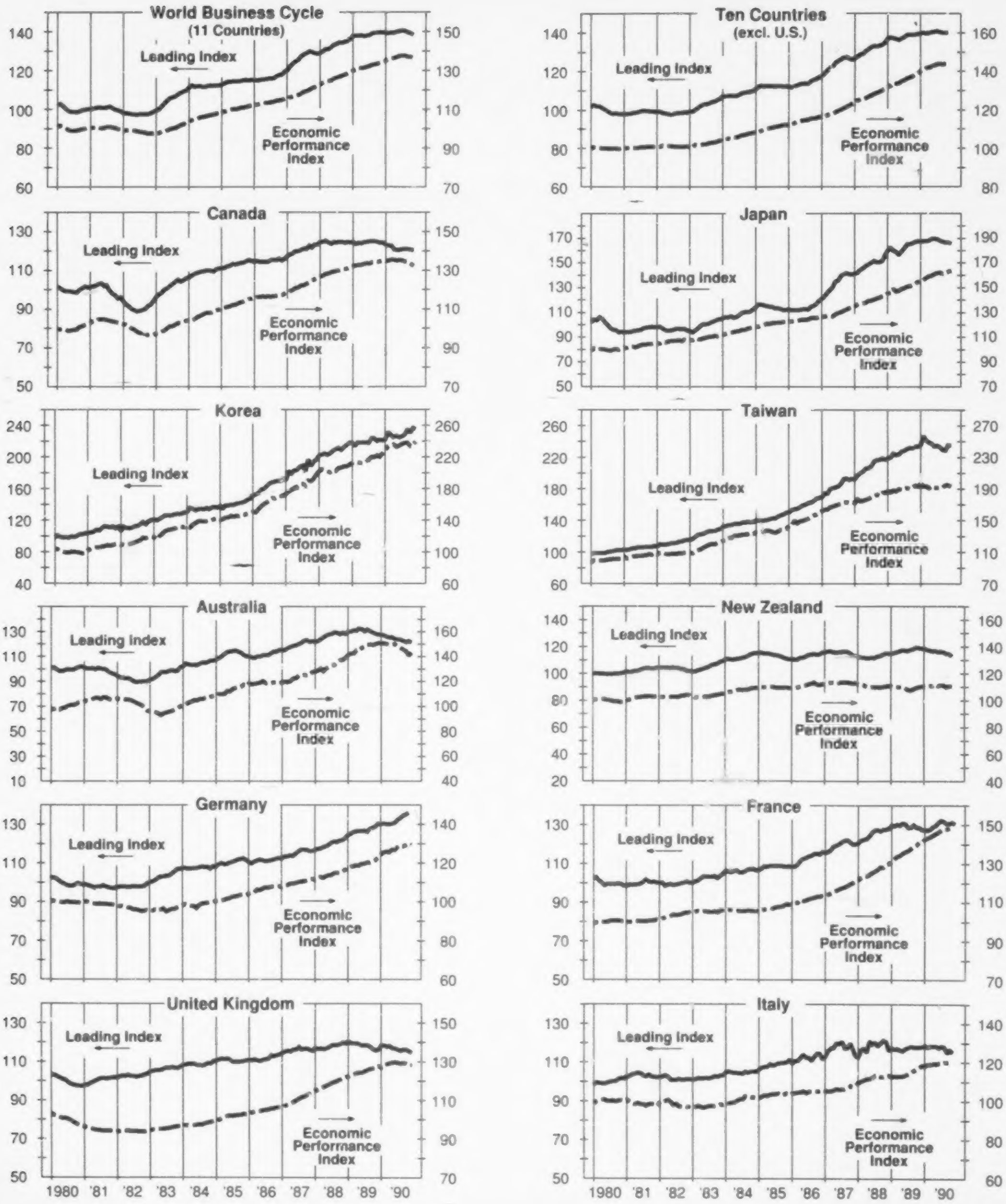


* Core Inflation = CPI excluding food at home and energy.



* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

A Nearly World-Wide Recession



Cyclical weakness is spreading throughout the industrial world. The first and most serious (thus far) recession began a year ago January in Australia. The other two countries currently in recession are Canada and the United States. Three others — The United Kingdom, New Zealand and Taiwan — seem to be on the verge of recession. Japan, France and Italy give off ambivalent signals; their leading indexes hint at a downturn, but their performance indexes have continued to climb. The two main exceptions are Germany and Korea, where both indexes continue to show strength.

(Source: Indexes from the Center for International Business Cycle Research at the Columbia Business School, as published in the Conference Board's monthly *International Economic Scoreboard.*)

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA		
Date of Forecast		Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.		
Gross National Product													
(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)													
		%	%	%	%	%	%	%	%	%	%		
Actual	1990 3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q 1990	Actual
	4Q	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	4Q	
Forecast	1991 1Q	-2.9	-1.6	-1.6	-3.2	-1.2	-0.7	-1.7	-1.3	-1.8	0.7	1Q 1991	Forecast
	2Q	-2.1	-2.5	-1.2	-0.1	1.4	2.7	3.7	0.5	-0.0	5.6	2Q	
	3Q	0.8	0.4	1.7	1.3	2.9	1.2	4.3	2.5	3.7	4.5	3Q	
	4Q	5.3	3.1	2.4	1.7	3.0	1.6	3.1	2.6	2.7	3.9	4Q	
	1992 1Q	7.8	3.0	3.2	2.7	3.0	2.4	4.2	2.8	3.6	1.8	1Q 1992	
	2Q	4.7	3.0	4.0	3.6	3.2	1.8	2.4	2.7	4.5	1.7	2Q	
	3Q	3.9		4.4	2.5	3.2	2.2	1.8	2.6	3.5	2.7	3Q	
	4Q	2.9		4.1	2.8	3.0	2.4	1.7	2.7	2.4	2.1	4Q	
	1993 1Q	2.0		3.8			2.4	2.5	3.0	2.8	2.5	1Q 1993	
Inflation (GNP Deflator)													
(Percent change from same quarter one year earlier)													
Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.2	4.2	3.6	4.0	4.1	4.2	2.8	2.9	2.9	2.8	1991 4Q	Forecast
	1992 4Q	2.6		3.9	4.1	4.0	4.6	2.7	2.5	3.0	3.4	1992 4Q	
Unemployment Rate													
(Percent, quarterly)													
Actual	1990 3Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	2Q 1990	Actual
	4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q	
Forecast	1991 1Q	6.7	6.5	6.4	6.4	6.4	6.3	6.7	6.3	6.5	6.3	1Q 1991	
	2Q	7.2	7.0	6.8	6.8	6.7	6.4	6.9	6.6	6.9	6.2	2Q	
	3Q	7.4	7.1	6.9	7.0	6.6	6.5	6.9	6.7	7.0	6.2	3Q	
	4Q	7.1	6.9	6.8	6.9	6.5	6.6	6.8	6.7	6.9	6.1	4Q	
	1992 1Q	6.5	6.6	6.7	6.7	6.4	6.5	6.6	6.6	6.8	6.1	1Q 1992	
	2Q	6.2	6.5	6.5	6.5	6.3	6.5	6.5	6.4	6.5	6.1	2Q	
	3Q	5.9		6.3	6.3	6.2	6.4	6.5	6.3	6.3	6.1	3Q	
	4Q	5.8		6.1	5.9	6.1	6.4	6.5	6.1	6.2	6.1	4Q	
	1993 1Q	5.8		5.9			6.3	6.4	6.0	6.0	6.1	1Q 1993	

Rebuilding the Financial Zoo

by Albert M. Wojnilower

The monetary monopoly exercised by the Federal Reserve is the anchor of our financial system. It is this monopoly that enables the Federal Reserve to keep a lid on monetary creation during booms and to prevent monetary contraction in times of business recession or financial crisis. Although financial in character, the Federal Reserve's monetary powers also constitute the essence of our safety net for the real economy.

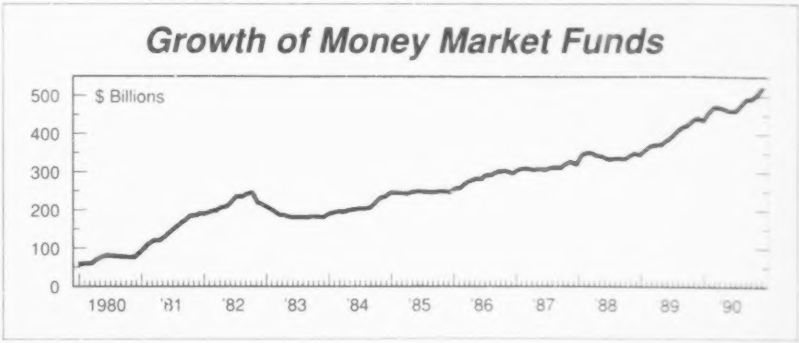
The better the money substitutes the financial service industry develops, and the greater the money-like liquidity it can provide for the broadest possible range of assets, the more it will prosper. Its way to success is through ingenuity in drawing the official safety net around private obligations. The private sector's chief incentive is to stretch and dilute the central monetary monopoly by creating financial claims whose convertibility into cash the Federal Reserve is expected to validate. Commercial banks had a head start by virtue of their effective monopoly on direct access to the Fed's discount window and exclusive franchise for the "sale" of checking accounts. The invention in 1962 of negotiable CDs, and later similar devices enabled banks to accumulate vast funds that from the holders' view remained immediately convertible into cash. But soon banks were hoisted by their own petard. Money market funds were able to persuade the public that they, too, were safe and instantly liquid. Since money market funds do not have to pay for deposit insurance, are free of other costly bank regulations, and do not need to process vast volumes of small checks, they have been able to skim the cream off the banks' personal deposit business (see chart).

Along another front, the banks and thrift institutions' loan business was siphoned away through the process labeled "securitization," which exploits the safety net in a different way. Another instructive form of securitization is the huge commercial paper market, in which large companies sell their unsecured short-term obligations to the public.

Let us look at this from an aggregate perspective. No matter how many financial institutions there are, they cannot on their own expand or contract the quantity of money. They may try, but the Federal Reserve has the job and the power to frustrate such efforts. In actuality, the Fed aims to maintain the long-run growth of money at a pace more or less equal to the sum of potential GNP growth and the acceptable rate of inflation. Absent inflation, this growth rate might be three percent a year at most. That unexciting rate would bound the growth of the financial sector, were it not for its considerable talents in erecting so marvelous a pyramid of assets, liabilities, and bets, and promoting faster trading and turnover in these instruments. But this inventiveness is self-limiting. When too successful, the new instruments drive the old out of circulation. Money market funds and commercial paper are superseding bank deposits much as, long ago, bank notes drove out the previous metal coinage.

One policy option is to let the diverse monies compete with one another, accepting the inevitable crises that occur when losers are culled. Another choice is to legitimate the new devices by making them eligible as, or convertible into money, while at the same time bringing their quantity and growth under monetary control. That is the core significance of the Federal Reserve's broadening of its monetary targets from M1 to M1B, M2, M3, and so forth. Of course there is a third option, which is to prohibit or regulate out of existence the new inventions, thereby confirming the existing monopoly.

If we want the central bank to prevent inflation and deflation, but private firms to make the microeconomic credit decisions, we must expect the private sector continually to develop instruments which undermine the monetary standard and impair the power of the central bank. In practice, we will intermittently have to choose between forbidding use of some innovations or broadening the monetary standard in such a way as to regulate them. Since every such candidate for monetary inclusion will have different private sponsors, these decisions cannot avoid a political dimension.



Growth of Money Market Funds

Despite their inherently disruptive nature, we should not prohibit innovations because that would mean foregoing technological gain in the financial industry. But we must understand that the combination of a central bank, a private financial sector, and innovation decrees an endless swinging back and forth between regulation and deregulation. Sometimes we will want to let in fresh to displace stale air, but when it gets too chilly, we will need to close the window. No automatic mechanism can do this for us. There can never be total absence of regulation because the underlying monetary monopoly is always eroding and in need of shoring up or redefinition.

The Monopoly is Fragmented

With this principle as background, let us examine the current difficulties of the American financial industry. As recently as the mid-1960s, it would have been correct to describe our financial system as a well-kept zoo. Different species, such as banks, securities dealers, insurance companies, and so forth, were neatly kept in separate cages segregated by function and geographical scope. The bars between cages prevented the various species from preying on one another. Within each cage, as in a real zoo, there was competition as respects the pecking order, access to the best food, and so forth, but vigilant keepers made sure this never led to serious injury or death.

Now this tranquil order has disintegrated. Many forces combined to undo the multitude of sheltered oligopolies. A major new element was the internationalization of the world economy. Another was the quantum leap in electronics, which rendered even more obsolete the geographical restrictions and generated new and cheap techniques (such as securitization) to provide services that cut across the traditional functional boundaries. The new technology became a means for the more ambitious institutions to engineer their escape.

But probably the chief source of change, stronger than internationalization or technology, was the shift in the prevailing ideology, which overtook animals, keepers, and public alike. Supervisors who not long before had zealously stamped out every small trespass lost faith in the validity of the regulations they were charged to administer and now condoned or even tacitly encouraged evasive techniques invented in the marketplace.

As recently as the mid-1960s, it would have been correct to describe our financial system as a well-kept zoo.

Deposit insurance and the other dimensions of the federal safety net always had posed a potential "moral hazard." They tempted lenders to take undue risks — heads, I win; tails, the government loses. Interest rate ceilings and the other competitive restraints, however, largely removed the incentive and the capacity for responding to the lure. Of all the competitive restraints, the ceilings on deposit and loan interest rates were probably the most constraining. These rules suffered severe attrition during the 1970s and were virtually repealed by the mid-1980s. Abrogation of the rate ceilings demolished the zoo, with predictably traumatic consequences.

On removal of barriers and reduction of subsidies, every denizen of the overpopulated zoo became both predator and prey. The interest rates they had to pay moved up faster than the rates that, with stiffer competition, they could charge. To preserve their size and growth, institutions had no choice but to compensate for squeezed profits by hungrily reaching for greater loan volume in unfamiliar markets. Lending standards eased everywhere. The inevitable result was a huge growth in debt, a significant fraction of which, equally inevitably, turned out to be unsound.

Meanwhile, the zookeepers continued to be held responsible for keeping alive most individuals of size, even though they might no longer be functional. More and larger casualties began to drop into the safety net, becoming a sizable drain on the public purse, the most serious instance so far being the wholesale collapse of the savings and loan industry. But unless vigorous preventive medicine is instituted, other parts of the financial sector surely will follow.

The thrift problem and its difficulties of resolution have much in common with the abuse and disintegration of state-run enterprises in the communist countries and Latin America. These institutions were in effect afforded open-ended calls on the public purse, a privilege they converted into huge windfalls for themselves (in the U.S., for homeowners and real-estate developers). But tearing down the institutions does not automatically generate others to take their place.

The natural reaction is revenge. Throw the rascals out! But the previous incentive structure, however antisocial, also attracted the most economically savvy individuals. Despite their alleged sins in responding to the incentives, they are possibly the most knowledgeable about doing the job better (and surely strategically placed to pursue a "scorched earth" policy against those trying to oust them). In the case of our S&Ls, the current political bloodlust is such that many persons experienced in real estate (analogous to communist factory managers) are effectively excluded from acquiring the properties the government wishes to liquidate. The government's agents also are afraid, because of the public's anger, to sell at prices low enough to allow the buyer to turn a profit. In effect, properties may only be sold to persons who don't know the business and certainly not at a price at which they might make money.

As the writedown of real estate values spreads through the country like a chain letter, other prominent real estate lenders such as banks and insurance companies are sucked into the downdraft. Parts of the securities industry (notably the retail side) also are in moribund condition. Whether or not the Federal Reserve yet fully realizes this, it is in serious danger that lender-of-last-resort priorities will eclipse its monetary functions. There is a vast quantity of financial instruments whose conversion into money, at orderly or even fixed prices, has been explicitly or implicitly guaranteed by the authorities. Careless deregulation has allowed our financial fabric to become so closely interwoven that almost every financial instrument that is widely held and traded has to be protected.

The Authorities Make Matters Worse

Although central bankers might disagree with this statement of the situation, they are aware of the problem. But, the supervisory path they are following is suicidal with respect to the preservation of their monetary independence, and lethal to our financial system's ability to support a risk-taking and internationally influential private sector.

Financial institutions cannot compete. They cannot compete with nonfinancial businesses because their own aggregate growth potential is limited by national monetary targets. Because loss of confidence in any group of institutions can easily be infectious and because the safety net must and does protect at least the larger of the losing institutions, no significant segment of financial business can grow rapidly without soon causing serious systemic problems such as we are currently experiencing. The American financial zoo is especially vulnerable to collapse from internal competitive stress. There are simply far too many institutions being kept alive, for any of them to have decent earnings in a noninflationary environment.

How to Improve Current Policies

Current U.S. financial policy includes three strands each of which, although correct in ultimate intent, seems certain in practice to make matters worse. They are 1) encouraging institutions to broaden the range of their services; 2) forcing them to improve capital ratios; and 3) limiting the scope of deposit insurance. As presently pursued, they are doomed to fail, but the approach developed here suggests how they might be modified to give them a chance to achieve their good intentions. Firstly, as to the "decompartmentalization" of the industry, I fully concur that breaking down the barriers, whether geographical or functional (as, for example, the Glass-Stegall Act that separates the banking and securities business), is necessary and unavoidable. Indeed, I have reached the reluctant conclusion that interlocks with nonfinancial firms are desirable. More fundamentally, universal banking is desirable because it comes closest to insuring that financial change will develop within rather than outside the regulated sector.

> *Pushing house cats into the jungle is not liberation but murder.*

But how to achieve this objective? Simply to allow or urge our existing financial institutions to universalize, as we are doing, is a recipe for disaster. It pushes the specialized animals out of their familiar cages to venture into others for which they have no experience and which are already overcrowded with species specially adapted to that environment. Pushing house cats into the jungle is not liberation but murder. Unless we want to risk a crisis, any program that intensifies competition must be accompanied by one that facilitates orderly exit.

Unpleasant as it may be, the government must offer sizable subsidies to force the liquidation or merger of existing institutions. The carrot would need to be substantial and so would the stick. After a stipulated deadline for taking up the exit subsidy, surviving institutions would lose the shelter of many anticompetitive regulations, and firms failing to meet capital standards would have their top managements automatically discharged and incremental deposits, insurance reserves, brokerage accounts, etc., declared ineligible for deposit insurance and other official backstops. The objective should be to decimate the number of firms, affording the survivors a reasonable prospect of profitable operation and capital access.

It would be expensive. But most observers would agree that this is how, long ago, the savings and loan problem should have been treated. It is, indeed, how we are dealing with it now, but at far greater expense than had we started sooner. The choice with respect to other parts of the financial industry is only whether to act now or to wait until we are forced to do the same things at greater cost in a crisis.

The second approach the authorities hope will mitigate the conflict between their macroeconomic and safety-net responsibilities is the enforcement of tighter capital rules. If bank shareholders had more at risk, it is argued, they would force managements to be more careful. Since the regulatory crunch rules out gathering capital by earning more through lending more, the only course left to banks to strengthen their capital ratios is to shrink assets. But there is simply no way for the financial industry to increase its aggregate capital except in a growth environment.

The gridlock has to and will be broken. In a world with no competing currencies or central banks, sharply lower interest rates might do the job, but that no longer is the world in which we live. Two steps are necessary. First, as was done during the mid-1980s oil price collapse, examiners should value properties not on current transaction prices, but on some longer-run average. ("Mark-to-market" is absurd in this context; for example, if all assets had been valued on the night of the stock market crash, October 19, 1987, most private firms would have been forced into bankruptcy. That, by the way, is what the bank examiners wrought in the 1930s.) Second, the Fed will have to implement its national target for credit growth on the individual bank level. In a variation on "community action" standards, the authorities will need to require individual institutions to adhere to national or regional credit growth standards for at least that part of their loan book which has passed examiner inspection, granting them forbearance with respect to any adverse effect of such loan increases on capital-asset ratios. It is certain that less forbearance will be needed in such a growth environment than will turn out to be unavoidable under the current pressures for shrinkage.

The third and most explosively dangerous aspect of official policy is the attempt to narrow deposit insurance. Today virtually all liquid assets that are not **de jure** government guaranteed are held only because they are deemed to be guaranteed **de facto.** Indeed, holdings are shifting noticeably in the **de jure** direction. A widely publicized change in the rules, such as the proposed reduction in the number of permissible insured accounts, could easily turn the present stream of funds toward fully backed governmental securities into a torrent. The short-term result would be a credit crunch similar to the "disintermediation" crunches that used to occur when government security yields rose above the interest rate ceilings, leaving financial institutions helplessly exposed to a hemorrhage of deposits. Those episodes were easily stanched by a Fed-engineered drop in open-market interest rates. Financial intermediaries suffered liquidity drains, but these didn't last long enough for capital to be seriously impaired. One can only conjecture what heroic measures would be needed today to stop deposit bleeding due to capital inadequacy.

A run into government securities would lower their yields while rates soared on private obligations subject to credit risk. When the government can borrow freely and cheaply while the private sector can do so only with difficulty and at much higher rates, the channeling of capital flows and investment decisions through the government becomes a political certainty. In toying with deposit insurance, the authorities risk triggering a depression as well as the complete nationalization of the capital market.

One may have a great deal of sympathy for the government's effort. The authorities do ultimately have to prevent the limitless stretching of the safety net, but this is difficult to accomplish when confidence is low. The objective is to draw boundaries for the safety net, but it has to be done without panicking all the people who live on or outside the boundaries into destructively rushing inside. One suggestion for moving gradually in this direction would be to abolish the $100,000 limit on deposit insurance, while imposing an interest-rate ceiling on insured accounts at a level lower than government-security yields at corresponding maturities.

The objective should be to decimate the number of firms, affording the survivors a reasonable prospect of profitable operation and capital access.

In Short

This essay has attempted a far from complete or precise effort to define some principles for the operation of our financial system and to draw some practical consequences from them. The economic and financial safety net is a marvelous human invention, but cannot be all encompassing without subverting monetary stability. It is desirable, in principle, that the boundaries of the safety net be sharply demarcated. In practice, however, an alert and technologically advancing private sector continually creates innovations that attempt to accelerate monetary and credit growth beyond the national standard by blurring and stretching these boundaries. Some but not all of these innovations are worthwhile. They should not, however, be allowed within the net unless and until provision is made for the orderly closing down or expulsion of the obsolescent process the innovation displaces. As a counsel of perfection, this can best be accomplished in a system composed of a few giant "department stores" of finance, which are de facto guaranteed perpetual life but expected to maintain significant birth and mortality rates among their departments.

The American financial system, by contrast, consists of a large number of specialized stores, many or most of them unlikely to survive. This puts in doubt the credibility of the safety net, since a misconstrual of its borders, either by the public or the authorities, could trigger a cascade of defaults. The danger is growing of an implosion of the private financial sector into an entirely government guaranteed market, in which the extent and nature of government underwriting becomes the chief arbiter of private credit access. Intentionally or not, current supervisory policies are intensifying rather than mitigating this risk. I have offered the suggestion to subsidize the exit of sick institutions, enabling them, as it were, to retire or be absorbed rather than die; to use the supervisory function to promote the growth rather than the shrinkage of the stronger institutions; and to make a cautious start at remarking the limits of the safety net, by insisting that the public accept lower than government-security interest rates on fully-insured deposits.

Albert M. Wojnilower is Senior Advisor, First Boston Asset Management. This essay is excerpted from a paper he delivered November 30, 1990, at the Fourth Special Financial Conference sponsored by the American Committee on Asian Economic Studies, in cooperation with the Federal Reserve Bank of San Francisco, and the University of California at Berkeley.

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The Conference Board

Volume 2, Number 4 April 1991

Economic Times

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Serving Business and Society for 75 Years

Editor's Note

This month we again offer our quarterly round-up on the outlook for various industries — see the special (shaded) center section — prepared by specialists in each of the industries.

Next we have some fascinating facts about state lotteries. I can remember when gambling was widely thought to be a sin, but now you're almost unpatriotic if you don't support education by buying a lottery ticket.

Speaking of sin, our next item presents some new international data on debt — data compiled by C. J. Lawrence Inc., to whom we are grateful — comparing the use of debt in four major countries. Then still another thought about the credit markets is provided by John Paulus.

On the opposite page, our faithful Colloquium panel ranges widely across the horizon in telling us about the most important issues the country faces today. Interestingly, debt is not mentioned.

Ed Fiedler

Maxim of the month:

Smile! It makes them wonder what you're up to!

Who Killed Eastern Airlines?

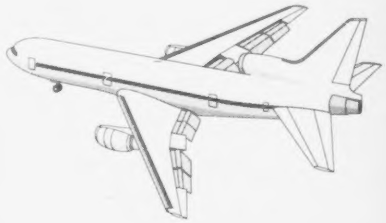
Eastern Airlines is gone and, although I sometimes wax nostalgic, not this time. I'll shed no tears for Eastern.

Most news stories about the event labeled it a disaster and pursued an inquisition to identify the guilty parties. There is of course a long line of "usual suspects," including Saddam Hussein, the regulators, and the deregulators. Former CEO Frank Lorenzo was perhaps the most "popular" choice. He in turn wrote an "op-ed" piece blaming earlier management, the National Mediation Board, and (mostly) the labor unions. The head of the flight-attendants' union responded in kind with a letter-to-the-editor returning the onus to Lorenzo. The flap was mostly babel, generating little light.

But Eastern's demise doesn't deserve a noisy scapegoat search any more than it deserves tears. Why not? Because little if any damage is being inflicted on the economy. Yes, the investors are stuck, but that's standard. And some travelers are left with unusable tickets, and some employees will have to find new jobs, not easy in short order when tied (as most of us are) to a local community.

But for the economy as a whole, what havoc has Eastern's disappearance wrought? Is there a shortage of capacity on the New York-Florida run? Clearly not. Have fares to Puerto Rico skyrocketed in response to a sudden absense of competition? Again, no. Other airlines have bought up Eastern's gates and landing rights. Few passengers have been denied a wide choice of flights on the routes that Eastern flew.

The way the media handled Eastern's demise, it seems to me, is rather typical of our attitude about such developments. Bankruptcy is always thought of as a catastrophe and as a failure of the economy. But think back! Does anyone miss Packard or Studebaker? How about W.T. Grant? Or Braniff? Duz doesn't do everything any more, but somehow we still get our clothes clean. Any mourners for Wings cigarettes? Or *Look* magazine?



The point is that what has happened to Eastern, while not an everyday occurrence, is really just standard procedure in our competitive system. The inefficient and stodgy companies are *supposed* to give way to the innovative and efficient. Competition always looks chaotic and wasteful, especially if viewed from inside a company that's affected. Even when viewing it from an economy-wide perspective, it's a mistake to expect competition to be neat and orderly.

But the reality is that the occasional failure of inefficient firms, widely regarded as "bad news" for the economy, is in fact normal and beneficial to society. Indeed it is a crucial part of the process by which the nation's standard of living improves. No fun for the firm's employees and investors, to be sure, but normally good for all the rest of us. Thus, no tears for you, Eastern Airlines.

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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Colloquium

Background:

The Gulf War, a great success, is over and attention is turning again to the many economic and social problems we must deal with near- and long-term, at home and abroad.

Question:

To your way of thinking, what is the most important issue we face now?

Jim Tobin
Yale University

It's time for us Americans, beginning with President Bush, to climb down from our euphoric patriotic high as Number One in warfare and confront our Number One status in urban pathologies — homicides, guns, crimes, incarceration, addiction, homelessness, poverty, dependency. Improvements in health, education, housing, employment, and family stability in inner cities are our most important issues, national as well as local. Enough of empty rhetoric! Let's have real and sustained presidential leadership, federal money too.

Andrew F. Brimmer
Brimmer & Company

In the Post-Gulf-War period, the most pressing economic problem we face as a nation is the stimulation of *investment* — in plant and equipment, R&D, public infrastructure, and human capital. To meet this need, Congress should adopt a series of sharply focused incentives tied to specific reductions in corporate and personal income taxes. These should include a sizable investment tax credit and substantial allowances for education and training — but *not* lower taxes on capital gains.

Robert G. Dederick
Northern Trust Company

With the recession still proceeding apace, the key issue for most of us — economists definitely not excluded — is our own income, current and prospective. But, when taking a less personal view, I conclude that the most *pressing* issue for the American superpower is how best to deal with the continuing dissolution of the Soviet empire, while the most *important* issue is how best to achieve lasting peace in the Middle East. Or perhaps it's the other way around.

Murray Weidenbaum
Center for the Study of American Business

Considering the many members of Congress eager to spend the nonexistent peace dividend and to enact more rounds of burdensome legislation, the major public policy challenge now facing the country is how to get them to leave quickly. Like the ancient Chinese who paid physicians when they were well, we should give members of Congress stipends for staying home. If they must legislate, their motto should become, "Don't just stand there, undo something."

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

The Economics of State Lotteries

by Charles T. Clotfelter and Philip J. Cook

The implicit taxes levied on the purchase of lottery tickets are extraordinarily high.

State lotteries are notable for their broad market penetration and rapid growth. Since 1963, 32 states and the District of Columbia have created lotteries, and it's a good bet that other states will follow in the next few years. Sixty percent of the adults in lottery states play at least once in a year. The annual growth in real per capita sales in lottery states has averaged 12 percent from 1975 to 1989.

On average, half of all lottery revenues are returned in the form of prizes, a ratio that is much lower than that offered by other forms of commercial gambling such as bingo (74 percent), horseracing (81 percent), or slot machines (89 percent). The "profit" goes to the state treasury. These transfers can be thought of as implicit taxes levied on the purchase of lottery tickets, and are extraordinarily high, averaging 40 percent of gross revenues.

The product line offered by state lotteries today bears little resemblance to the games available in the early 1970s. The lotteries' first major innovation was the instant game ticket, offering players a chance to discover immediately if they had won a prize. The second new lottery product was a daily numbers game, a computerized imitation of the illegal game that has long been popular in many cities. This game (like its illegal counterpart) lets players choose their own numbers, thus providing an opportunity to become actively involved in the gambling process.

The on-line computer network that supports the numbers game also made it possible to offer a third major lottery product in the early 1980s: lotto. This game features long odds and huge jackpots that build from one drawing to the next if there are no winners. With jackpots reaching as high as $100 million, lotto has garnered enormous public interest.

Why People Play

A lottery ticket is a risky financial asset, offering a prospect of prizes in return for an investment of 50 cents or a dollar. Since the expected value of the prizes is typically only half the ticket price, the question naturally arises as to why the risky prospects offered by lottery games appeal to people who exhibit some aversion to risk in other circumstances. One argument is that people who gamble at unfavorable odds may perceive a disproportionate benefit to a prize that is large enough to elevate their social standing, and be willing to pay a premium for that sort of chance.

A quite different explanation is that when the odds against hitting the jackpot are several million to one, such probabilities are well beyond the realm of experience gained from playing the game, and as a result players cannot be expected to have much intuition about their chances. Faced with such a remote chance, people tend to assess the prospect on the basis of considerations such as the ease with which instances of the event can be brought to mind. In the case of lotteries, the ability to visualize such instances is aided by the steady stream of winners who are announced each week with considerable fanfare and by the advertising.

Lottery advertising accentuates the possibility of winning with themes like, "Somebody's going to win. Why not you?" Such messages, implicit or explicit, help make the dream of wealth credible. Such ads may tend to produce an exaggerated sense of the likelihood of winning. A gamble which is objectively unfair may thus be perceived as

Drawing by W. Steig; © 1988
The New Yorker Magazine, Inc.

attractive by people who normally are averse to risk.

Who Plays the Lottery?

Most adults who live in lottery states have played the lottery at least once, but a small percentage of lottery customers are so active as to account for the bulk of all sales. In any given week about one-third of all adults play.

Socioeconomic patterns of lottery expenditures have received considerable attention. Men play somewhat more than women. Adults play more in their middle years than when young (18 to 25) or old (65 and over). Catholics play more than Protestants, approximately half again as much. And lottery play is systematically related to social class, although perhaps not always as strongly as the conventional wisdom would suggest in this regard. A survey in California found that the proportion of adults who participated during one week in July 1986 ranged from 49 percent for those with less than a high school education to 30 percent for those with a college degree. Retired people and students played least of all. With respect to race, survey evidence suggests that Hispanics in the west and blacks in the east play more than non-Hispanic whites.

Remarkably, the same sources of data do not demonstrate any consistent relationship between lottery play and household income over the broad middle range; the average expenditure in dollars for households making $10,000 is about the same as for those making $60,000. One implication of this pattern of demand is that the tax implicit in lottery finance is regressive, in the sense that as a percentage of income, tax payments decline as income increases.

The tax implicit in lottery finance is regressive. But the prizes are the stuff that dreams are made of.

The Peculiarities of Lotto

For the game of lotto, bigger is better. Small states appear to be unable to mount a lotto game that attracts much public interest because the jackpots are inevitably small compared to the multimillion-dollar bonanzas generated in California and New York. The reason hinges on the role of the jackpot in attracting lotto action. An example may help explain how this works.

Suppose state A has an adult population of 10 million and state B has only 100,000. Given equally attractive games, we assume that lotto purchases in both states will average $1 per capita at each drawing. In state A the initial jackpot is then worth $2.5 million, compared with only $25,000 in state B. If both states set the probability of winning at 1 in 100,000 with the average price per winner the same in both states, then state A will have an average of 100 winners while state B will have one winner. Given these rules, the games in the two states do not appear to differ much. However, state A has the option of reducing the probability of winning to, say, 1 in 10 million, in which case each state has only one winner on the average.

Under these rules, state A offers one hundred times the jackpot of state B, and only 1 percent of state B's probability of winning. For reasons discussed above, most players prefer state A's game to state B's. The prize in state A is the stuff that dreams are made of. The offsetting large difference in probabilities between the two states has little influence on potential players. As long as most drawings produce a winner, the prospect of winning will be credible in both states.

What's the Purpose?

As they are presently constituted, state lotteries are guided by one objective: to raise as much revenue as possible for state treasuries. This is evident in the lotteries' high tax rates and heavy advertising. The lottery agencies could increase payout rates to levels typical of other forms of commercial gambling, increasing consumer surplus at the expense of state revenue collections. Another option would be to require lottery agencies to disclose more information on the probability distribution of prizes, and to be more candid in characterizing the value of jackpots paid out in the form of annuities. Restrictions on advertising, of the sort currently in effect in Virginia and Wisconsin, could be adopted in other states. However, states appear to have little enthusiasm for making any major changes in what has become a popular and profitable formula for raising revenue.

Excerpted from the *Journal of Economic Perspectives,* Fall 1990. Charles T. Clotfelter and Philip J. Cook are professors of Public Policy Studies and Economics at Duke University, Durham, North Carolina. Their book, *Selling Hope: State Lotteries in America,* was published by Harvard University Press in 1989.

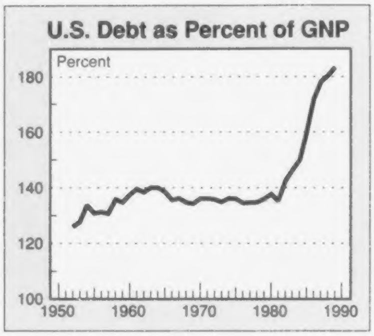
Till Debt Do Us Part

By Edgar R. Fiedler

The hefty increases in debt during the 1980s in all sectors of the U.S. economy were a source of widespread 'the-country's-going-to-the-dogs' handwringing by pundits and professionals alike. As the top chart reveals, after three decades of stability, the 1980s increase in the total debt-GNP ratio was indeed dramatic.

> *If debt is a sin, the United States has not been the lone sinner.*

Stephanie Pomboy and Ed Hyman at C. J. Lawrence have now pulled together some comparable data on nonfinancial debt in four of the largest economies, and the comparisons are fascinating (bottom chart). If high and rising debt is a sin, it turns out that the United States has not been the lone sinner. Japan, often regarded as the paragon of economic performance, uses more debt and has increased its debt over the past two decades faster than the U.S., indeed faster than any of the other three. The United Kingdom, although it is the only country of the four to experience a declining debt-to-GNP ratio since 1970, is still a bigger debt user than the U.S. Only Germany is lower than the U.S., and even that financially conservative nation has seen its ratio rise as sharply as the U.S. ratio over the past two decades.

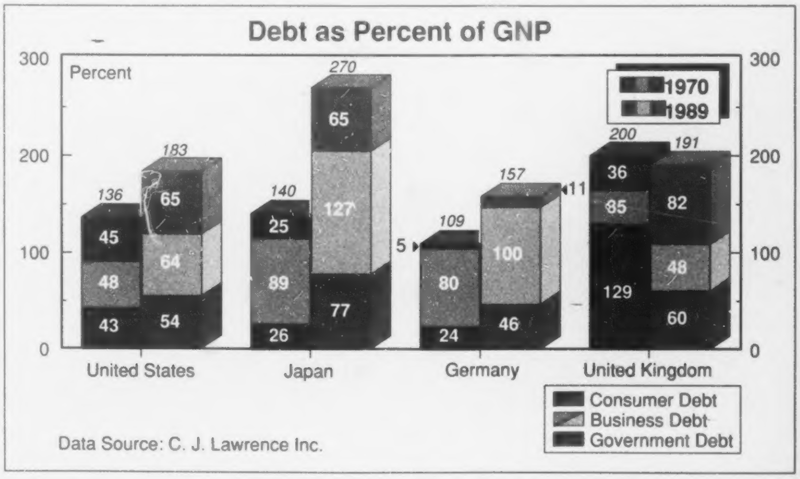


A glance at the sector-by-sector debt numbers (again measured as a percent of GNP) also provides some surprises. The biggest shock (to me at least) is the Japanese ratio of consumer debt to GNP, the fact that it is now the same size as ours and has increased so explosively since 1970. The British ratio is even higher. Consumers in Germany, however, deserve their reputation for frugality, judging by their nearly invisible (11 percent) debt ratio.

The business and government debt ratios are not especially remarkable, except for the stunning drop since 1970 in the British ratio of government debt to GNP. Evidently Mrs. Thatcher's privatization programs made an enormous difference.

How much comfort should anyone who worries about the economy overdosing on debt derive from these comparisons? Are the numbers we see here telling us that the *whole world* is coming to an end simultaneously? Or should we conclude that maybe the world is *not* coming to an end after all? Many years ago, before I looked into this quality-of-credit issue (and learned just how amorphous and impenetrable it really is), I worried about it quite a lot. I still worry about the nation's saving-investment ratio (another issue that is much more complex than I once thought). But on the debt bet, my nickel (no more) is on the optimistic side.

> *On the debt bet, my nickel (no more) is on the optimistic side.*

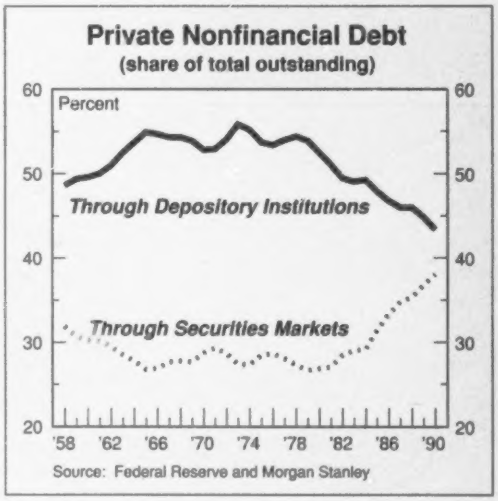


Data Source: C. J. Lawrence Inc.

Quotable Quote *by John D. Paulus*

Looking ahead over the next few years, one of the major issues is how much impact the present paralysis in the banking system might have — by retarding total lending in the financial system — on economic growth. The issue is addressed in the accompanying chart, the top line of which shows the sharply reduced share of private credit created through the commercial banks, savings and loan associations, and other depository institutions.

Such worries, however, ignore the second line on the chart, which shows how securities-market lending — principally commercial paper, corporate bonds and mortgage-backed securities — is taking up a portion of the slack let out by the more conservative loan policies of the distressed depositories. This shift in the composition of lending has been in progress since the early 1980s, with the securities market share now up to 40 percent. Thus, while the contraction in lending by the banks and S&Ls *could* pose a serious problem for economic growth if securities-market intermediation were to decline as well, at this time there is no reason to believe that such a retrenchment is imminent.



Private Nonfinancial Debt
(share of total outstanding)

Source: Federal Reserve and Morgan Stanley

John D. Paulus is Managing Director and Chief Economist at Morgan Stanley. This commentary is excerpted from his essay, "Economic Growth and Structural Challenges in the 1990s: The Case for Optimism," in *Economic Perspectives*, February 1991.

Only in New York City

The silliness of St. Patrick's Day in New York City used to be confined to green bagels and green beer, but that was a more innocent age. Today, special-interest politics has lifted the vacuity to new heights, and the *New York Times'* coverage (March 17, 1991, front page) of the city's 230th Saint Patrick's Day parade reads as follows:

Late for a parade that he had passed up the chance to lead, Mayor David N. Dinkins was booed for nearly 40 blocks yesterday and briefly showered with beer as he and other elected officials marched up Fifth Avenue with a gay Irish group in the St. Patrick's Day Parade.

The Mayor, who had threatened not to march at all, ducked under an umbrella when two beer cans sailed toward him.

But that did not shield him from the rolling chorus of taunts and epithets and angry signs protesting his decision to join ranks with the lesbian and gay group, which the parade organizers had barred until Mr. Dinkins intervened.

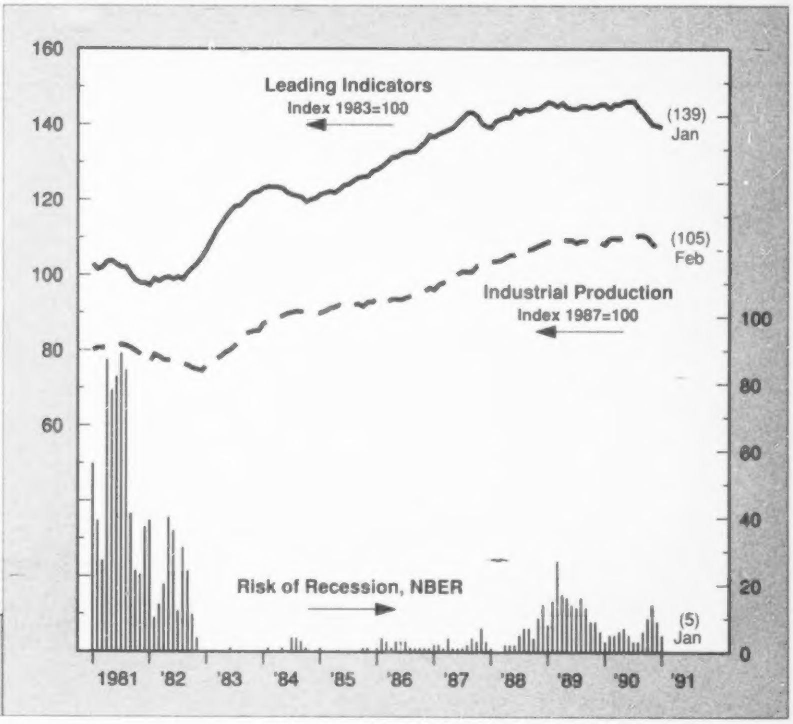
Governor Mario M. Cuomo also gave up a place at the front of the parade, marching with a group of handicapped children in wheelchairs that had been denied a place among the bands and bagpipes until they threatened to sue the parade organizers....

I don't know whether to laugh or cry.

Conference Board Stat File

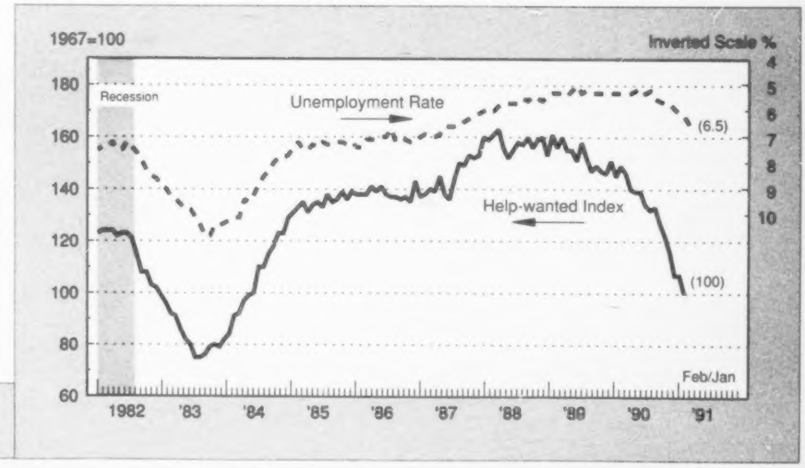
As the charts on this page illustrate, the downward phase of the business cycle continues to dominate the comprehensive economic indicators. On the following two pages, however, (and in other data) we find hints of a recession bottom beginning to take shape — in, for example, the momentum and confidence indexes. The recovery in consumer expectations is no surprise, given the victory in Iraq, but the fourth-quarter strength in capital appropriations is decidedly out of pattern. It's still too soon to say recovery is imminent, but not too soon to consider that possibility. The disturbing element in the current picture is the stubbornness of inflation. We still believe some slowing of the inflation rate lies ahead, but why hasn't any of it showed up by now?
(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)

Early Warning Indicators



Leaders and production are still portraying a garden-variety recession; NBER calculation is thoroughly strange.

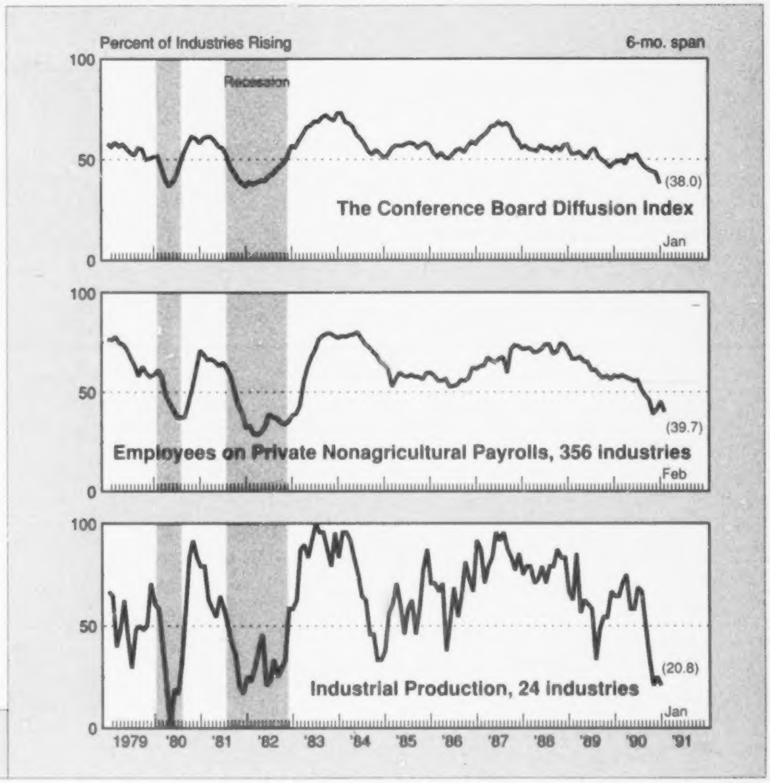
Help-wanted Advertising and Unemployment



No signs of a turn in the labor markets.

Conference Board Stat File

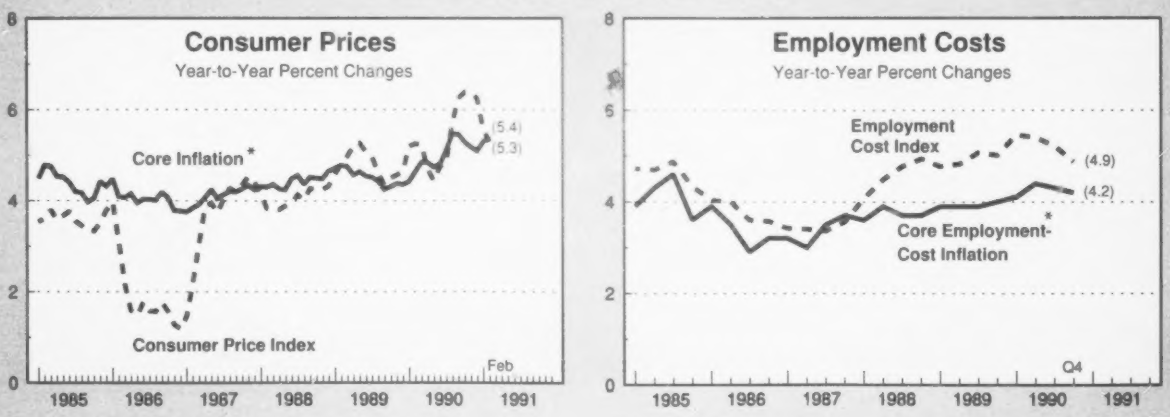
Indexes of Economic Momentum



Some hints of a bottoming in cyclical momentum.

Inflation momentum persists — disturbingly.

Inflation Fundamentals



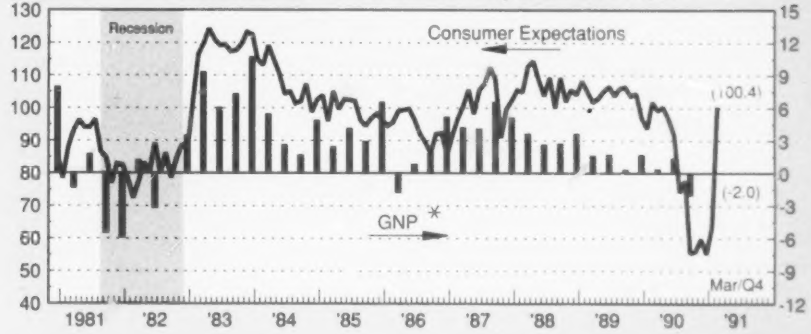
* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

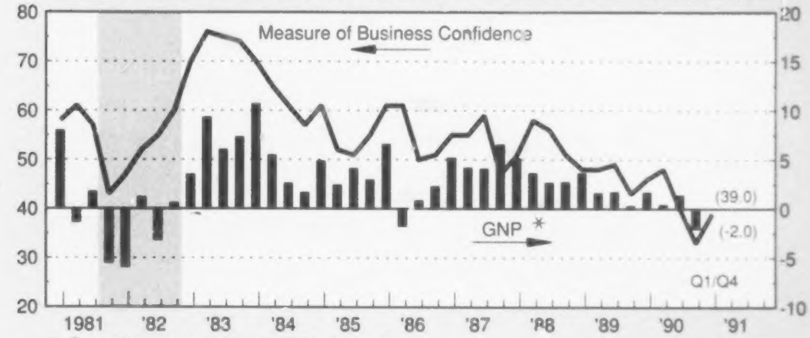
Conference Board Stat File

Confidence

Conference Board Consumer Expectations Index



Conference Board Measure of Business Executives' Confidence

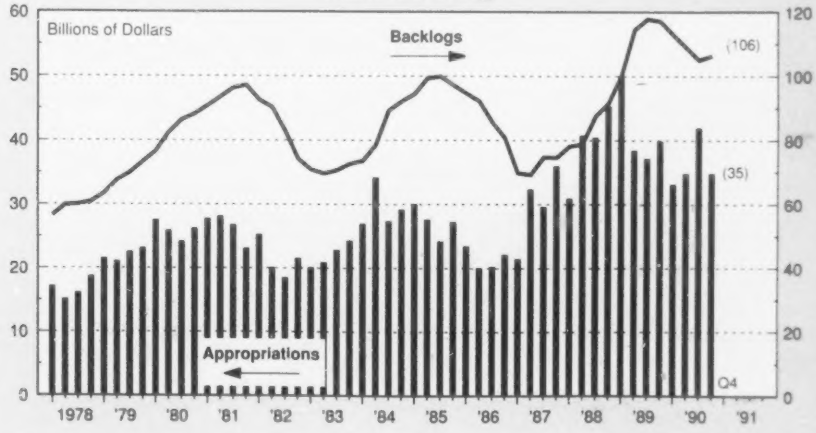


* Quarterly percent changes in GNP at annual rates

Confidence improving — encouragingly.

Investment Intentions

Conference Board Capital Appropriations Manufacturing



Appropriations holding up surprisingly well.

Inside the Crystal Ball

			UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Date of Forecast			Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

			%	%	%	%	%	%	%	%	%	%	%		
Actual	1990	3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q 1990	Actual
		4Q	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	4Q	
Forecast	1991	1Q	-2.5	-1.6	-1.0	-2.2	-2.2	-0.7	-2.0	-2.5	-2.3	0.5	-0.9	1Q 1991	Forecast
		2Q	-1.0	-0.8	-0.2	1.9	1.9	2.6	4.1	0.5	0.1	4.8	1.5	2Q	
		3Q	1.8	0.4	2.4	2.7	3.3	1.3	6.1	2.8	4.2	3.8	3.0	3Q	
		4Q	3.2	3.1	2.8	1.4	3.1	1.6	3.4	2.5	3.3	3.0	2.8	4Q	
	1992	1Q	3.9	3.0	3.2	2.7	3.0	2.4	3.2	3.2	3.5	3.2	2.9	1Q 1992	
		2Q	4.3	3.0	3.2	2.1	3.2	1.8	2.1	2.7	3.8	2.8	3.3	2Q	
		3Q	3.9		3.7	3.3	3.2	2.2	2.4	2.6	3.1	3.0	3.7	3Q	
		4Q	2.6		4.0	1.5	3.0	2.4	2.0	2.5	2.3	2.6	3.6	4Q	
	1993	1Q	2.8		3.8			2.4	2.3	3.1	3.1	2.8		1Q 1993	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

Actual	1990	4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991	4Q	3.7	4.0	3.6	4.1	4.1	4.2	2.7	3.2	2.9	2.8	3.8	1991 4Q	Forecast
	1992	4Q	2.6		3.9	3.9	3.9	4.6	2.7	2.5	3.1	3.1	3.6	1992 4Q	

Unemployment Rate

(Percent, quarterly)

Actual	1990	3Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	3Q 1990	Actual
		4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q	
Forecast	1991	1Q	6.4	6.3	6.4	6.3	6.3	6.4	6.5	6.3	6.5	6.4	6.5	1Q 1991	Forecast
		2Q	6.8	6.9	6.8	6.4	6.6	6.5	6.8	6.6	6.9	6.5	6.8	2Q	
		3Q	6.9	7.0	6.8	6.4	6.5	6.6	6.7	6.7	7.0	6.1	6.8	3Q	
		4Q	6.7	6.9	6.8	6.6	6.4	6.6	6.5	6.7	6.9	6.0	6.7	4Q	
	1992	1Q	6.5	6.6	6.7	6.6	6.3	6.5	6.4	6.6	6.7	5.9	6.7	1Q 1992	
		2Q	6.3	6.5	6.5	6.6	6.2	6.5	6.3	6.5	6.5	5.9	6.6	2Q	
		3Q	6.1		6.3	6.3	6.1	6.4	6.3	6.3	6.3	5.8	6.4	3Q	
		4Q	5.9		6.1	6.2	6.0	6.4	6.3	6.2	6.2	5.8	6.3	4Q	
	1993	1Q	5.8		5.9			6.3	6.3	6.0	6.1	5.8		1Q 1993	

Industry Outlook Report

April 1991

Overview

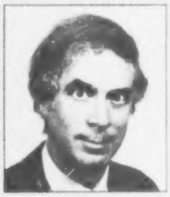
Edgar R. Fiedler
The Conference Board

The industry specialists reporting on the outlook for the next year or so reflect a curious mix of nonchalance and pessimism--quite typical, I believe, of the current views of the U.S. forecasting fraternity. The nonchalance is about the recession. It doesn't worry them much at all. They don't expect the slide to go very far, either in depth or in duration. Except for John Macleod, our somewhat more concerned friend from Down Under, it's likely none of the group would argue strongly with a projection that the recession will end around mid-year.

At the same time, the group's expectations about the recovery are uniformly restrained. Dave Berson's forecast of "a fairly modest increase in [home] sales,...compared with previous economic expansions" is typical. Correspondingly, Tom Will sees "shipments of original equipment auto tires [dropping] some six million units" in 1991, along with a "replacement market that is flat to down." Thus while the recession is not a matter of serious concern to the group, prospects for the subsequent recovery are anything but a cause for celebration.

Perhaps the most difficult question about the outlook for 1991 and 1992 is how much it will be affected by the troubles of the banking industry. The consensus view is that the depository institutions — the commercial banks as well as the thrifts — are nearly paralyzed by their problems in real estate and elsewhere. Thus they will not be willing to support a cyclical recovery with the same kind of free-wheeling lending policies they normally deployed in past recoveries. Bill Dunkelberg, however, says 'tain't so. The small businesses in his survey simply are not reporting serious trouble in finding credit — nothing like 1981-82. That is an intriguing piece of evidence, although it will not, I'm sure, be universally accepted at face value by all our readers.

Health



Jack A. Meyer
New Directions for Policy

Health care costs have been rising about 3.8 percentage points more than the growth in our nominal gross national product. In the absence of major structural reforms in our health care system, this trend will continue. This would push health spending from an estimated $670 billion in 1990 to about $745 billion in 1991 and about $830 billion in 1992. By the year 2000, health costs would total nearly $2 trillion under this forecast, accounting for over 17 percent of GNP, compared with about 12 percent today. At the same time as costs are soaring, at least one of eight Americans has no health insurance, while millions more are under-insured.

Powerful forces are pushing health costs upward. New medical technology is being developed at a rapid pace. Federal tax and subsidy systems underwrite the over-consumption of health care services even as they leave large segments of low and moderate income families out in the cold. The aging of our population, AIDS, drug and alcohol abuse, and our medical malpractice system, all add to health-care costs.

The business sector can help by, for example, encouraging the delivery of care in cost-effective settings, and emphasizing early detection, diagnosis and screening. Government policy reforms can support these private initiatives. The government can place a ceiling on the open-ended exclusion of employer contributions to health insurance from employees' income tax liability. The additional revenues could fund a broadening of publicly assisted health coverage through either refundable tax credits earmarked for insurance premium contributions or Medicaid expansion.

Government and the private sector can sponsor research to uncover unnecessary surgery and questionable diagnostic tests. Regulatory reforms could include limits on insurers' ability to deny coverage to people in high-risk categories or to price such coverage beyond their reach. Tort reform could also help control astronomical settlements in malpractice cases. Given the explosion of medical technology and looming demographic changes, however, we will also have to make greater use of rationing if we are to decelerate the growth rate of health care costs.

Electronics

Richard O'Brien
Hewlett-Packard

The worldwide market for electronic equipment and components increased from $710 billion in 1989 to $760 billion in 1990, a modest growth of 7 percent. U.S. industry performance was boosted by a surge in exports, as the domestic market was constrained to a 4 percent growth rate. 1991 is expected to be another modest year. However, a small upturn in the medium-term will follow as the investment cycle strengthens.

The computer sector grew modestly in 1990 at a rate of 7 percent. Given the shaky financial results of 1990, and the predicted downturn in capital equipment spending in early 1991, computer equipment will probably post another mediocre performance. A strong rebound is predicted in 1992, as the decline in the dollar will still translate into robust export growth rates.

The size of worldwide military procurement budgets will continue to be the single most important factor affecting growth in communication equipment demand. Communications equipment, primarily military electronics, will probably capture a larger share of the declining U.S. defense budget. Fast-growing segments include local area networks, satellite terminals, fiber optics, the cellular segment, navigation equipment, and communication services. Telecommunication equipment will be susceptible to the economic downturn in 1991. Growth in communication equipment should resume in 1992.

The components industry continued to decelerate in 1990, with the pace of growth at 4 percent. Growth has been impacted by the slowdown in the computer and telecommunications industries. However, the current industry cycle is apparently bottoming. Because the downturn has been relatively mild, the recovery expected in 1991 will not be as sharp as in past cycles.

The demand for instruments is forecast to remain slow for most of 1991, reflecting lower overall growth in plant and equipment. Test and measurement is impacted by the downsizing of defense orders and an uneven pattern in commercial orders. Luckily, dollar-denominated international shipments benefit from the slide of the U.S. dollar. Analytical instruments will also slow in 1991, but long-term prospects remain good. Renewed emphasis on the environment and accuracy in testing will contribute to growth. Medical electronics has been a standout for its growth rate and relative lack of volatility.

Tires and Rubber

Thomas F. Will
Goodyear Tire and Rubber

In the 1980s, the industry was caught up in the takeover and merger frenzy. When the smoke cleared, three companies, Goodyear, Michelin/UTG, and Bridgestone/Firestone, accounted for 58 percent of the world's tire supply. Consolidations promoted reorganization and nurturing of total quality environments. In 1990, these merged companies, eager to move ahead, fell into a severe struggle for market share. This situation was exacerbated by the slowing economy and the Iraqi invasion of Kuwait. As a result, the industry's 1990 profitability was destroyed.

Outlook

As the industry headed into 1991, consumer confidence and vehicle sales were at recessionary levels, and the Middle East war was on the immediate horizon. Plans were made to accommodate demand and production levels close to 1982 recession levels. Fortunately, the gloomy outlook has eased somewhat with the successful conclusion of the lightning quick 43-day war. This may buoy consumer confidence and move the consumer away from CNN to the retail mall.

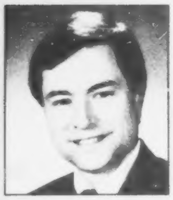
Even so, auto and light truck sales could fall some 8-10 percent, and industry shipments of original equipment auto tires could drop some six million units.

Growth in the replacement auto tire market is dependent upon miles driven per vehicle. We anticipate that this will flatten out this year. Coupling this with lower registration growth and longer-wearing tires will result in a replacement market that is flat to down in 1991.

On the truck tire side, truck tonnage and small business activity plummeted in the last few months of 1990 and remain at a low level. Tire demand for medium and heavy trucks will be 10 percent below 1990 levels. Demand on the replacement side will follow any pickup in consumer buying. For the year, look for replacement truck tire demand to be flat at best.

With low demand levels in an industry with too much supply, we look for industry profits to be slim in 1991 but much improved in 1992.

Housing



David W. Berson
Federal National Mortgage Association

The housing market typically leads the economy into recession, and the current downturn has proven to be no exception. In the year ending January 1991, housing starts declined by nearly 45 percent, new home sales dropped by almost 35 percent, and existing home sales were down by about 16 percent — with most of the declines occurring after the Iraqi invasion of Kuwait in response to the sharp drop in consumer confidence. The initial slowing in the housing market last year came as a result of dwindling pent-up demand after strong sales and production years in the 1980s and tougher lending standards for builders — not the typical affordability problems that usually afflict the housing market before recessions.

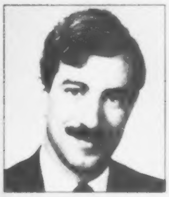
If, as most expect, the U.S. economy turns around in the second half of 1991, the housing market, too, should recover. This recovery, however, is likely to be both more uneven and less robust than usual. Home sales should rebound more strongly than home construction over the second half of the year, with rising consumer confidence and the highest levels of affordability since the late 1970s. Mortgage lenders have already seen a substantial rise in applications to refinance existing mortgages, and a pickup in consumer confidence coming from the successful end of the war should soon boost sales. A lackluster economic recovery combined with only small increases in pent-up demand are likely to lead to a fairly modest increase in sales, however, compared with previous economic expansions. Housing starts may lag behind sales because of builder caution and continued tight depository-institution regulation that makes it more difficult for builders to borrow funds, especially for acquisition and development purposes.

For 1991 as a whole, both new and existing home sales should be similar to their levels of last year—a combined total of about 3.8 million sales. Housing starts, however, are expected to decline by about 9 percent this year, to the lowest level since 1982 — about 1.09 million units.

Housing Starts
(millions)

1990 *(actual)*	**1991***(forecast)*
1.20	**1.09**

Freight Transportation



Kenneth D. Simonson
American Trucking Associations

All transport modes had a bumpy ride in 1990. Soaring fuel prices, a sharp loss of confidence by business and consumers, and a rapid military buildup in the Persian Gulf made for sudden swings in patterns of freight movements and costs for each mode.

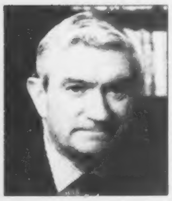
The remainder of 1991 and 1992 should be much closer to the normal pattern for freight transportation; that is, volumes will generally sink or rise with the level of industrial production. (industrial production will probably be a better bellwether than gross national product, since freight reflects goods production — almost by definition — and not services.)

Gradually, however, the fate of even the land-based modes is becoming more tied to foreign economies. Trucks, on which more than three-quarters of the nation's freight bill is spent, have charged into Canada in great numbers since Canadian deregulation and the Free Trade Agreement lowered the barriers. Truckers are eager to do the same in Mexico. Rails have been delivering increasing quantities of freight to and from ports, thanks to through trains hauling double-stacked containers.

Air and ocean freight may get a small fillip from the rebuilding and demobilization in Kuwait, but this will not be enough to make up for sluggishness in other export markets or for a slow recovery in the U.S. appetite for imports.

No dramatic shifts are likely in how the freight bill is divided among modes. Instead, look for continued consolidation within each mode — at an accelerated rate if recovery does not come soon.

Minerals



John D.S. Macleod
CRA Limited
(Australia)

The outlook for mineral volumes and prices is for a period of further weakness. The main driving force, and the main variable, is the condition of the major world economies.

As I write it is clear that world economic growth is slowing, the English speaking nations are in recession, and recovery (especially in the US) if it occurs later this year is likely to be weak. The growth locomotives in the World are Germany and Japan. Many of the smaller Asian economies could well be included in this growth leader group.

For the minerals industry to prosper we need World GNP growth of 2.5 to 3.0 percent per annum. Such growth is unlikely in either 1991 or 1992. On this basis some further weakening of metal prices could occur although the big falls that have already occurred may mean that present prices may be close to the bottom. Remember that the price of aluminum is off 33 percent from its peak last year, copper 30 percent and zinc 36 percent.

The world mining and processing industry entered this period of slowing world growth in most unusual conditions. Supply and demand for most metals is in near balance. Inventories are modest for this stage of a cycle but, even more unusual, new capacity added over the past year or so has been relatively modest. Finally, producers have lowered their debt levels and many go into this downturn with strong balance sheets.

The reasons why capacity additions have been so modest in the past two or three years are interesting. The first half of the 1980s was a period of inadequate prices, excess capacity and high gearing. When market conditions improved, the rising profits were used to repay debt, increase dividends and upgrade plant and equipment. It was also a period when gold dominated the industry; in particular, mineral exploration expenditures were focused almost exclusively on gold. The result has been many new gold mines but few other major orebodies.

Conservation, environment, heritage, national parks and native lands are all factors which hindered new mineral development in the '80s. They remain as a big question mark over future supplies of minerals and energy in the '90s.

Small Business

William C. Dunkelberg
National Federation of Independent Business

The small business economy continued weak in early 1991, but the latest survey of attitudes among small-firm executives shows a recovery in optimism from the depressed levels of late 1990. About two-thirds of last year's decline in attitudes was retraced by this February, but sentiment remains low, indicating a weak near-term economy.

In line with the general economy, expected business conditions for the nation's independent enterprises remain very soft. Hiring plans are weak, indicating that unemployment will continue to rise. Inventory positions are in a healthy condition, but declining sales have nevertheless taken a toll on inventory satisfaction.

A large number of executives report that weakness in sales has forced them to lower selling prices. Indeed, sales projections for the year ahead are anemic. Declines in sales are outpacing cost reductions, taking a toll on cash flow and profits. In turn, capital spending plans among independent business people have remained at a low level for six months now, and are likely to sag further until a general economic rebound appears.

Credit Crunch? During this recession, much has been made of the idea that many banks are *unusually* reluctant to lend to borrowers to whom they would have willingly lent in the past. Members of the National Federation of Independent Business have been surveyed regularly since 1973 about their borrowing experience. These surveys show that a modest credit crunch took place in 1974-75, and a severe crunch occurred in 1981-82. In the latter case, 32 percent of the executives surveyed reported credit to be harder to get, compared to only 14 percent currently, and 48 percent reported higher interest rates, compared to only 8 percent currently.

Furthermore, when Federation members were recently asked about their most important problem, taxes top the list, and "credit availability" is near the bottom. Doesn't sound like much of a CRUNCH, does it? It's not! The survey shows credit to have tightened somewhat in the past few months but, no, this is not anything that deserves to be called a "credit crunch."

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The Conference Board

Volume 2, Number 5 May 1991

Economic Times

INSIDE:

- **Housing Prices — Not Quite What You Thought** *(pages 4-5)*
- **Fuchs on Children** *(page 6)*
- **Colloquium Tackles Education Reform** *(page 3)*
- **Sommers on Inflation** *(page 7)*
- **Stat File and Crystal Ball** *(pages 8-11)*

Serving Business and Society for 75 Years

Editor's Note

This month our pages are filled with the analytical output of a lovable line-up of my cronies, erstwhile and present. Using data brought to my attention by Robert Neithart and Don Conlan of The Capital Group, I provide commentary on the centerpiece of the personal balance sheet of most families, the price of housing. Victor Fuchs, who helped us better understand women's pay last September, takes up this time around the issue of investment in children. Our Colloquium panel wrestles with the same subject, by offering ideas on how education can be improved. And the dean of the Conference Board research staff, Al Sommers, takes another look at inflation through his multidimensional prism.

Over the past few months, to the already pre-eminent group that contributed to our "Crystal Ball" page heretofore we have added some new (to this publication) and renowned forecasters, namely Saul Hymans and his colleagues at the University of Michigan's Research Seminar on Quantitative Economics, Bob Dederick of Northern Trust, and Adrian Dillon of Eaton Corporation. This month, in addition, we have broadened the reach of these seekers-of-future-truth, by including a section on long-term interest rates. We hope you will find these rate forecasts helpful.

This issue marks our first anniversary and, as we said a year ago, please send along any ideas you may have to improve this publication. Thank you.

Ed Fiedler

Maxim of the month:

We learn from history that we do not learn from history.

Georg Friedrich Wilhelm Hegel

Both Spouses Working — Does it Pay?

The decision millions of traditional families with young children agonize about — should one spouse stay home with the children or should he or she augment the family income by remaining in the paid-work labor force — is an excruciatingly difficult issue. The serious complication that has long been understood is that once taxes and such job-related expenses as child care, work clothing and commuting are accounted for, the amount added to the family's income is a minor fraction of the second-earner's gross pay and often not enough to justify a decision to continue paid work (see examples).

Another important consideration that has come to be appreciated fully only in the past few years is the cost of interrupting a career for several years. By staying home the spouse loses the work experience, doesn't keep up with new developments in the field, and loses some working skills. Inevitably, then, the spouse returns some years later to paid work at a substantially lower salary than if he or she had remained on the job continuously — and is unlikely ever to close the gap.

To stay home with the children, therefore, means a permanent loss of earning power for the family. And should the marriage end in divorce — no small risk these days — the loss of income could be critical. For this reason, it may be a good idea to continue in the paid labor force during the children's early years, even though the after-tax-and-working-expenses pay is (for awhile) barely in the plus column.

There is, however, a further consideration here, one that is probably recognized intuitively by most parents but rarely receives much explicit attention in discussions of this issue. (One exception: Victor Fuchs, see page 6.) This is the reduced attention devoted to the children's education. When both parents are on the job at the office, they are absent from the child-raising job at home. No, I don't have in mind the parents teaching the children the alphabet with their ABC blocks and drilling them to memorize the Presidents. I'm thinking, rather, of what the children learn from seeing their parents interact with each other, overhearing their telephone conversations, and other everyday events. An important part of a youngster's development takes place in this fashion, and child-care personnel are not adequate substitutes.

The decision to continue or not to continue with paid work after childbirth is always a very personal one in which economic and other considerations differ widely from family to family. The balance is often highly uncertain, and no formula can determine what's best in each individual case. The greater opportunity to contribute to the children's development as an at-home parent should not be ignored in reaching that decision.

One or Both Working — The Monetary Impact

	Professionals, New York		**Blue Collar, Minneapolis**	
	One works	*Both work*	*One works*	*Both work*
Gross income	$70,000	$120,000	$25,000	$41,000
Taxes	21,848	44,534	4,734	9,047
Work-related expenses	0	21,405	0	5,651
Remaining amount	$48,152	$54,061	$20,266	$26,302
Difference		+5,909		+6,036
		=12%		=30%

Source: Price Waterhouse, The New York Times, *April 21, 1991*

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

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Colloquium

Background:

Education reform has long been a controversial issue, advocated for its own sake and as part of arguments about how the United States should improve its economic performance both here at home and in world markets. The Bush Administration has now weighed in with its own proposal.

Question:

What are the most important changes we need to make in education?

Isabel V. Sawhill
The Urban Institute

The education system is broken and needs to be replaced, not just repaired. The Bush administration's proposals are on the right track. The emphasis needs to be on experimentation, restructuring, and accountability, including a national system of tests. Parental choice is not the panacea that many think but is worth trying. The schools, of course, are only half of the story. Until children spend as much time studying as watching television, we will continue to lag our international competitors.

Laura D'Andrea Tyson
University of California, Berkeley

Before we gamble on an educational will-o-the-wisp such as the crazy quilt of parental choice, we would be well advised to emulate other nations with successful school systems by using first-rate teacher training, longer school years, national standards and testing, comprehensive pre-kindergarten childcare, and the elimination of local disparities in educational opportunities. Unfortunately, these old-fashioned approaches cost money and effort, while trendy slogans are cheap. The time for illusions is over — a real commitment of resources is past due.

Al Wojnilower
First Boston Corporation

Until parents and teachers can make home and school into extensions of one another, many children will remain unable to absorb the traditional curriculum taught in the academic manner. We need different, attractive, and well-financed schools for these youngsters. Placement should be by parental choice, with frequent options for reconsideration. This would promote learning in all "tracks" and foster competition for students among them. While some resources exist, meaningful nationwide reform depends on new Federal money.

Stephen H. Axilrod
Nikko Securities International

The question involves deep issues about society's values. As for educational practice itself, we need to use grade schools to restore the reading, writing, arithmetic, and organizational skills that are basic to the rest of learning and life performance. I would tip educational pay toward relatively higher pay for grade school teachers. In return, the quality of teaching should be improved considerably; individual salaries should depend on pupils' performance (judged by standardized tests); and parents should be given choice in both schools and teachers.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Your Best Investment Ever?

by Edgar R. Fiedler

Back in his younger days a friend of mine, when he'd had one too many, would ask total strangers, "How much is your old man worth?" He got few serious answers, of course, but he got lots of startled, open-mouthed expressions, which was really what he was after.

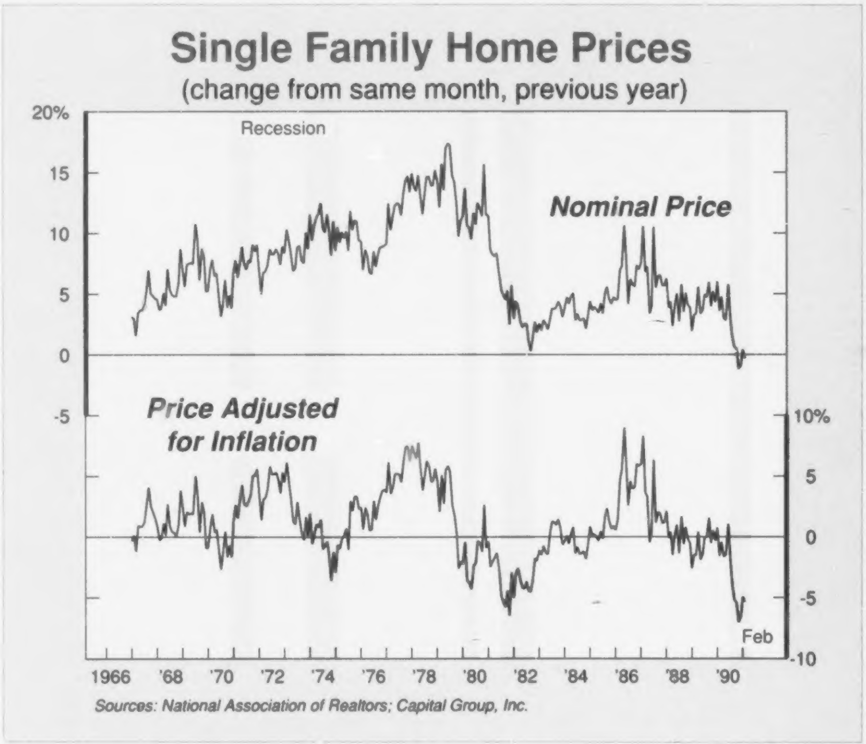
In most cases, how much your old man was worth then, or how much you are worth today, depends primarily on the value of the family home. In most families, it is *the* major asset and, since the price of housing has advanced over the decades, most homeowners have accumulated a tidy little net worth. Houses aren't purchased mainly for that purpose — they're bought mostly for their suitability as a place to live and to get the children started with their education — but the purchaser is always aware of the investment aspects of the decision.

With rare exceptions, the family home has been a good investment. Most have gone up in value, rather steadily. For the past 24 years (the period for which these data are available) prices of single family homes in the United States have increased almost continuously (see chart, top line). The only period when this has not been true, in fact, is over the past few months. This recent episode of falling prices hasn't been much of a decline, hardly noticeable one might think after a quarter century of rising prices. But no, it's not the sort of thing a homeowner is likely to ignore. Any decline in nominal home prices is a shock to an owner who has seen nothing but increases for decades. The subject dominates the conversation at neighborhood parties. For most families, the bedrock of their investment portfolio is showing signs of crumbling.

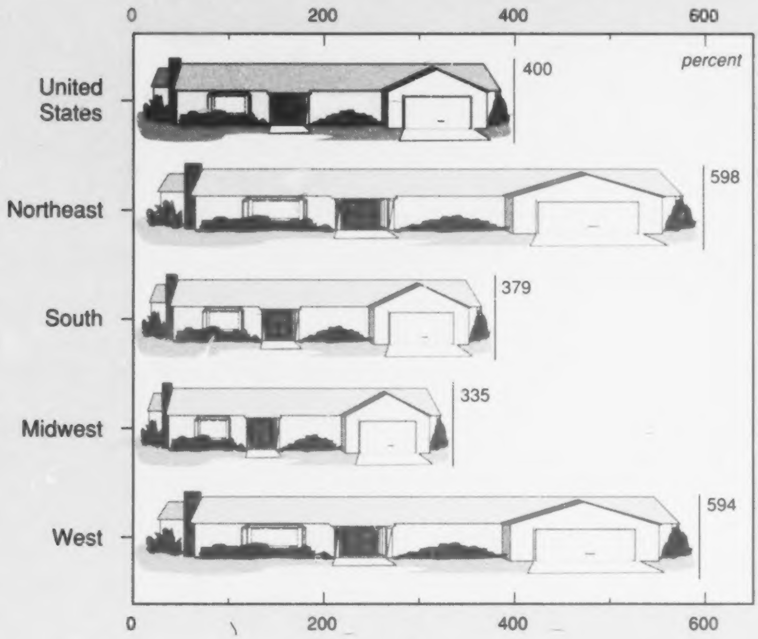
It's also revealing to examine home prices after adjusting for general inflation (the lower line on the first chart). Looked at this way, the historical record shows much more conformity with the general business cycle than is generally recognized. Indeed, on this basis, relative (inflation- adjusted) home prices declined in each of the five business recessions since the mid 1960s. Over the full 24-year period the real value of the typical U.S. home has appreciated nicely, but it wasn't the smooth, steady rise most of us thought it was.

This cyclicality of home prices does have one encouraging feature: It suggests that the recent decline in home values will not continue indefinitely. When the recession ends and the economy turns up — if the future follows the past (as most of us believe to some extent) — so will home prices. It's a comforting thought; there's a basis for hope that our bedrock isn't crumbling after all.

Returning again to the long perspective, we find that the increase in prices for the typical homeowner from January 1967 to January 1991 has been dramatic — 400 percent in nominal dollars. That gain is less impressive, however, when we note that inflation has lifted the general price level 310 percent over this same interval. Once the general inflation



Sources: National Association of Realtors; Capital Group, Inc.



Single Family Home Prices

Appreciation, January 1967 - January 1991

Sources: National Association of Realtors; Capital Group, Inc.

rate is factored out, the increase in value of the typical single-family house is reduced to a more prosaic 22 percent.

In many cases, the nationwide average is misleading, as there were large differences in price movements from region to region (and from one locale to another within the region). The second chart shows that on average home prices (in current dollars) in the Northeast and the West have risen twice as fast as in the Midwest and South. Thus, where you have lived in recent decades has made a dramatic difference in how much your house has added to your wealth.

And while we're analyzing homeownership in terms of investment (ignoring both the real and psychic benefits derived from living in the home), we can also compare the increase in housing prices against the return on common stocks and long-term Treasury bonds. This is shown in the third chart (also in nominal dollars), which reveals that the stock market has had twice the return as housing. The gains from housing and Treasury bonds, however, have been almost the same.

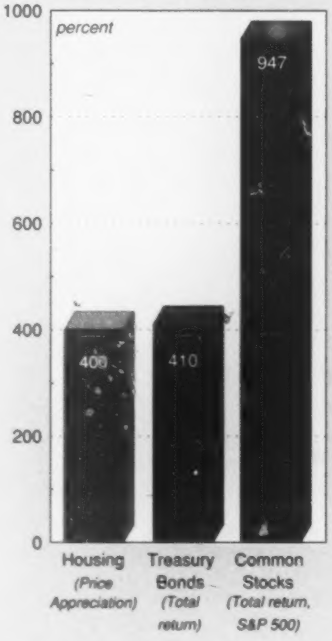
Are you surprised by this comparison? Do you have the feeling that you've gained a lot more on your house than you have on your common stock investments? Well, despite these figures your impression could very easily be accurate. Why? Because the comparisons mentioned above do not take into account the effect of borrowing. When we buy a house, virtually all of us borrow a large proportion of the purchase price, generally 75 or 80 or 90 percent, occasionally even more. And the interest rate we paid on the loan did not — during much of this 24-year period — compensate the lender for inflation, nowhere near. Thus the lender, although it provided most of the funds, gained nothing from the appreciation of housing prices; the homeowner reaped it all. This may no longer hold true, now that interest rates have increased so much relative to inflation, but it was a key factor up until the 1980s.

As a result, typical homebuyers of the 1960s and 1970s making a modest downpayment might well have realized a return on their investment several times as large as the typical stock buyer. Now it's true that stock purchases can be made on margin, too, but not many investors use borrowed funds to buy stocks, and even more rarely in such large proportions as in home buying. Thus, the impression many families have today that their home was the best investment they ever made is accurate.

Note: Data for this article were provided through the generous cooperation of Robert Neithart and Don R. Conlan of Capital Group, Inc.

Return on Housing, Stocks and Bonds

Jan. 1967 - Jan. 1991



Sources: National Association of Realtors; Ibbotson Associates; Capital Group, Inc.

Are Americans Underinvesting in Children?

By Victor R. Fuchs

According to many experts, American children are in trouble. Experts disagree about the reasons, but one theme surfaces frequently: the adequacy of our investment in children.

Not all the trends are unfavorable. The infant mortality rate, for instance, has been cut in half since 1970. But several measures indicate a deterioration. Probably the most highly publicized evidence is the Scholastic Aptitude Test, where scores declined substantially in the 1960s and 1970s. The decline occurred in all types of schools, among all socioeconomic groups, and in all parts of the country. Test results leveled off around 1980 and since then have risen slightly.

Another indicator is the rise in suicide in the 15- to 19-year-old age group. This rate more than doubled during a period when the rate among prime-age adults remained stable. The total number of teenage suicides is relatively small, but it is important to note that many more young people attempt suicide or kill themselves slowly through substance abuse.

Among children aged 6-11, the incidence of obesity, a major nutritional disorder that raises the risk of disease and psychosocial problems, jumped from 18 percent in the 1960s to 27 percent in the late 1970s, while superobesity doubled, from 6 percent to 12 percent.

Despite frequent expressions of concern, data on educational inputs show that Americans have not abandoned their commitment to public education. Between 1975 and 1987, expenditures per pupil in public elementary and secondary schools rose appreciably faster than GNP. Teachers' salaries tell a similar story. Compensation per public school employee grew faster between 1975 and 1987 than the average hourly earnings of all private nonfarm workers. Moreover, women who teach in elementary and secondary schools earn approximately 20 percent more than do comparable women in other occupations.

High average levels of spending on education do not, however, refute the claim of underinvestment in some children. In Texas, for instance, the 100 poorest school districts spend less than $3,000 per year per student, whereas in the 100 richest districts the average expenditure per student is more than $7,000.

Parents are usually the most important source of investment in children; they provide two kinds of inputs: those that are produced in the market and purchased with money and those that are produced at home. The latter can take a wide variety of forms, including health care, help with homework, love, discipline, and so forth. The amount of market inputs to children is determined primarily by family income. Recent trends in that measure have been very unfavorable for children. By the mid-1980s, the poverty rate among children (21 percent) was almost double the rate among adults (11 percent), a situation without precedent in American history.

No hard data are available that measure changes in the nonmarket inputs of parents to their children, but there are good reasons to believe that these crucial inputs have declined. Parental time potentially available to children (total time minus time in paid work) fell appreciably between 1960 and 1986. On average, in white households with children, parents had ten hours less per week of potential parental time; the decrease for black households with children was approximately 12 hours per week. The principal reason for the decline was an increase in the proportion of mothers holding paid jobs. An increase in one-parent households was also important, especially for black children. Not only are today's parents probably spending less time with their children than they did a generation ago, but time spent with them by grandparents, especially grandmothers, has almost certainly declined as well.

One other source of investment in children that is rarely discussed is the children themselves. Especially in high school, boys and girls often make large investments in themselves by doing homework, engaging in extracurricular activities, and the like. We don't know whether this type of investment has increased, decreased, or stayed the same. One clue that suggests a possible decrease is the large rise in the proportion of high school students who also have a paid job. The increase in employment is particularly evident among white middle-class high school students.

A Final Thought. Reaching broad generalizations about the adequacy of investment in our children is difficult. One conclusion is clear, however: A substantial fraction of American children is seriously disadvantaged. And since children are, to some extent, a public good, the entire society has a stake in the next generation. Regardless of progress with other issues, if Americans do not invest enough in children so that they become healthy, well-educated adults, the country's future is bleak.

Excerpted from David Blankenhorn, Steven Bayme and Jean Bethke Elshtain, Editors, *Rebuilding the Nest: A New Commitment to the American Family*, Family Service America, Milwaukee, Wisconsin, 1990. Victor R. Fuchs is Henry J. Kaiser, Jr. Professor at Stanford University and a Research Associate at the National Bureau of Economic Research.

Albert T. Sommers' Statistical Insight

No Easy Game for the Fed

Albert T. Sommers
Senior Fellow and
Economic Counsellor
The Conference Board

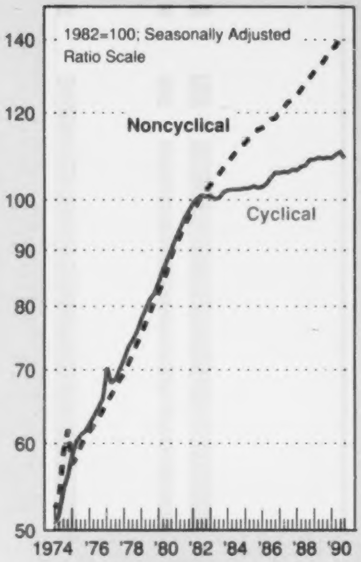
The word "inflation" describes an obviously important issue confronting policy makers in the United States, as in all developed economies. No argument there; but behind the legitimate concern over inflation lie some important issues to which attention is rarely directed. The word has harmonics that are often ignored; inflation is generally treated as a single, undifferentiated variable characterized only by a rate, and not at all by quality, or character, or composition, or causality. Agreed that inflation is a danger; treating it without fully understanding it is equally a danger.

It's widely understood that inflation should not be thought of simply as a price phenomenon. Wage and salary trends are an underlying component of the inflation rate. The cyclical strength of business influences inflation by fortifying (or weakening) markets, including the labor markets where the principal cost of doing business is determined. These are the familiar "demand-pull" and "cost-push" faces of inflation. Monetarists have taught us that excessive growth of the money stock is an ultimate underlying cause of inflation.

But much of the inflation now present in the U.S. economic system is traceable to structural conditions, institutional conditions and market imperfections, rather than to cyclical or monetary trends. The longer-term behavior of inflation in the United States reflects substantial departures from the conventional competitive equilibrium-seeking model embraced by economic theory. The departures were imposed through six decades of development of the "mixed economy." The U.S. economy today is a far cry from the pure competitive structure on which reasoning about inflation is conducted. **Modern inflation reflects not just how much business we are doing, but how we do the business.**

Moreover, this is an age of imperfect competition within markets, in which price increases are possible even when markets are operating far below capacity (e.g., the automobile market in the past six months). The recent behavior of prices suggests that weak business conditions have had a visible effect on prices in cyclical goods industries, and little effect elsewhere (see chart). The effects of policy restraints are much more pronounced in industries characterized by undifferentiated product — the so called commodity industries — than in industries characterized by differentiated, brand-named products. (Companies are eagerly seeking to escape from industries characterized by fungible, undifferentiated product, to rid themselves of the free-market disciplines that prevail in such industries.) Wholesale price indexes for intermediate and raw commodities, where product is generally undifferentiated and fungible, have been extremely weak, relative to highly differentiated finished goods product lines, where producers retain the power to administer prices.

Inflation in Cyclical and Noncyclical Markets



Sources: U.S. Department of Commerce; The Sommers Letter

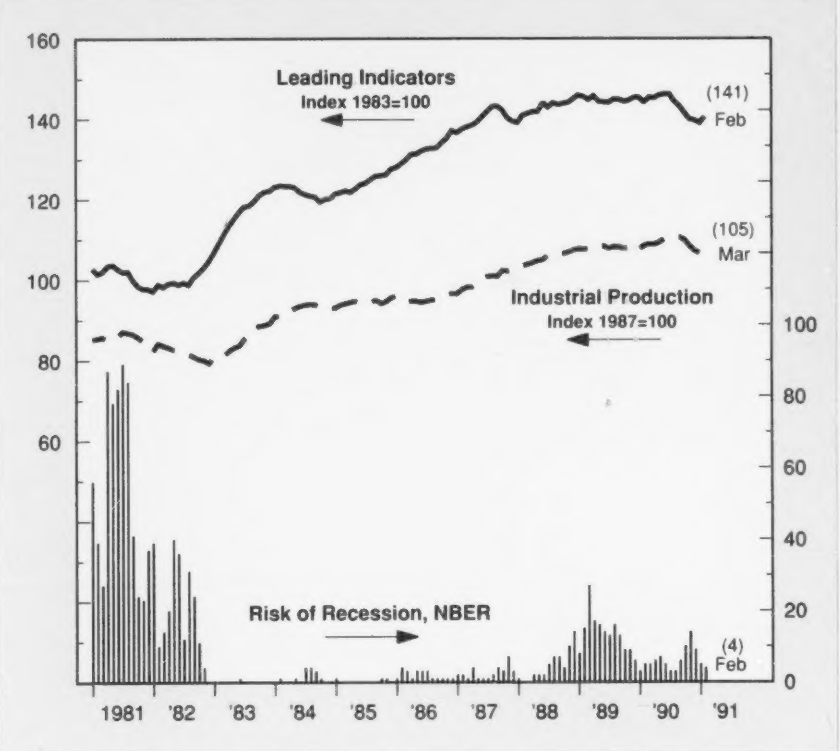
Finally, governments at all levels are searching for income to constrain swelling deficits, and some of their efforts will elevate measures of prices (in January, additional excise taxes, in February the postage increase, and up ahead heavy resort to user taxes and tolls).

No easy game for the Federal Reserve. The structural complexities of inflation mentioned here intensify the difficulty of subduing inflation and recession simultaneously. At this stage of the cycle particularly, fighting inflation with the conventional tools of monetary policy may be hazardous, and not very rewarding; most of the effort of restraint is likely to fall, as it has over the past nine months, on the real world rather than on an inflation rate partly insulated against conventional monetary weapons. —

Conference Board Stat File

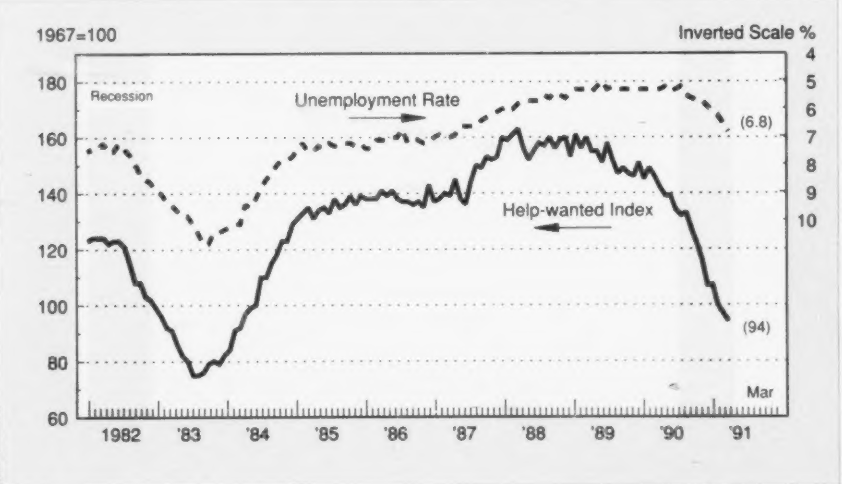
The winds of change are blowing briskly in the U.S. economy these days. A couple of months ago, almost all the statistical gusts were moving in one direction — down. But lately the crosscurrents have begun to swirl, most prominently stock prices and consumer expectations. Both have recovered all the ground lost in the second half of 1990. A few other early moving series, such as new housing permits, have begun to show signs of cyclical revival, although a tour d'horizon makes it clear that the full pattern is still very mixed. The economic headlines will continue to be predominantly black for some while yet. Nevertheless, we must remember that at troughs the change of cyclical direction usually takes place before much evidence of its arrival is published. Thus, even though the forecast risks remain high, it's time to take an unqualified position, to wit: That the recession will have reached bottom by Memorial Day is now even money. By Labor Day is odds-on. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



An encouraging hint of change is seen in the leading index.

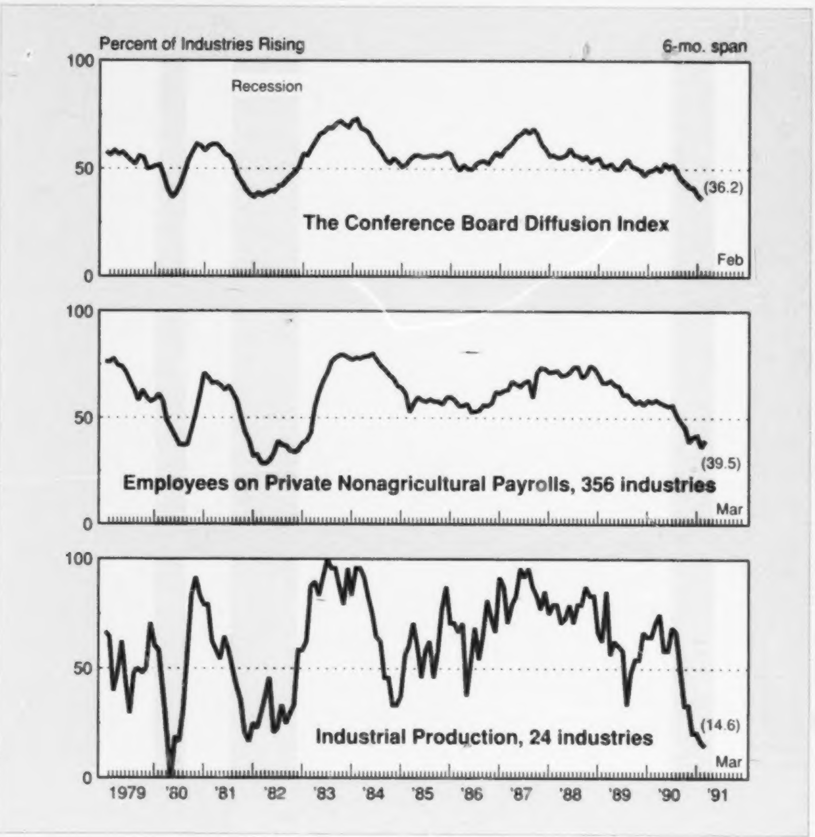
Help-wanted Advertising and Unemployment



Nothing but recession is to be found in these labor market indicators.

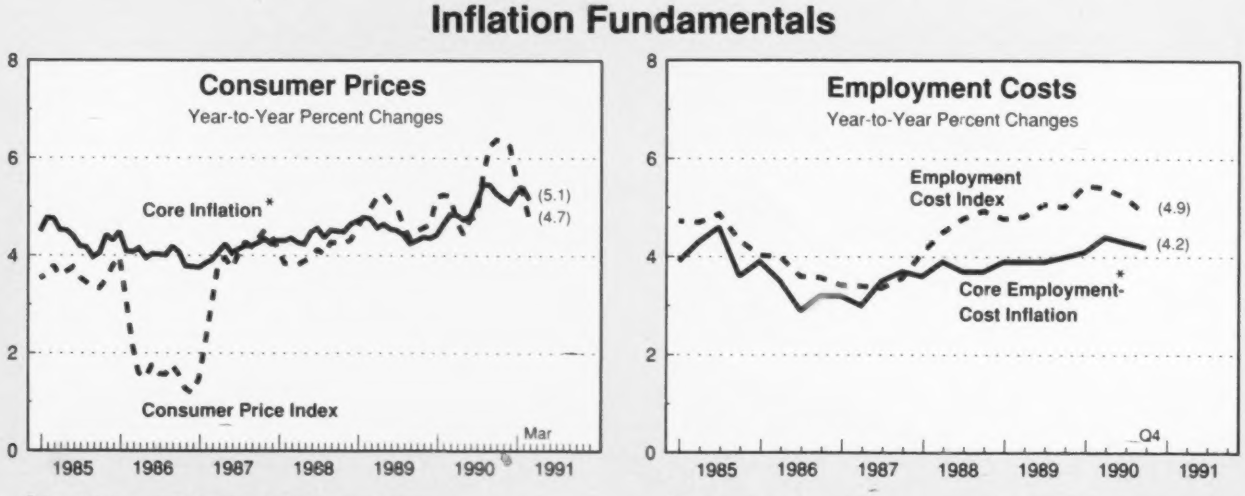
Conference Board Stat File

Indexes of Economic Momentum



Recession weakness is still spreading.

No signs yet of an easing of inflation.

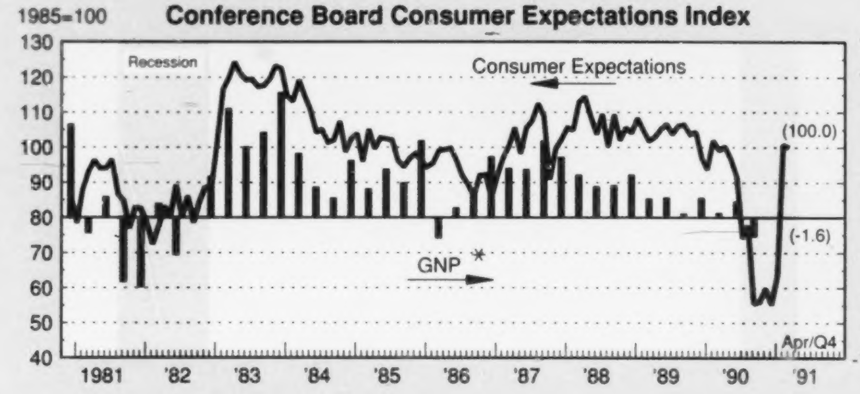


* Core Inflation = CPI excluding food at home and energy.

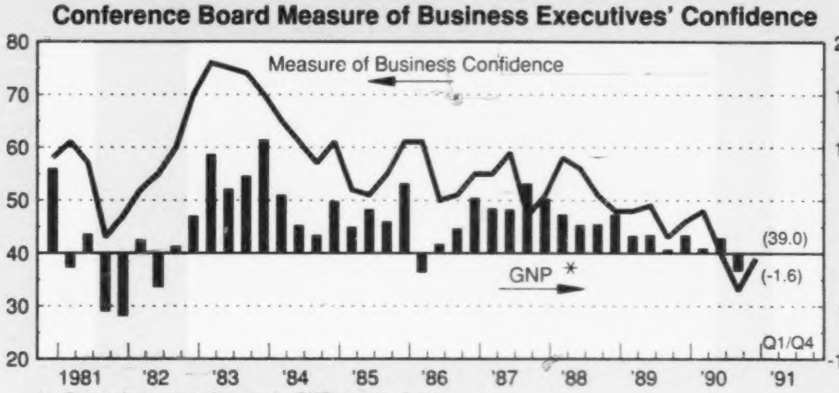
* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

Conference Board Stat File

Confidence



Conference Board Consumer Expectations Index

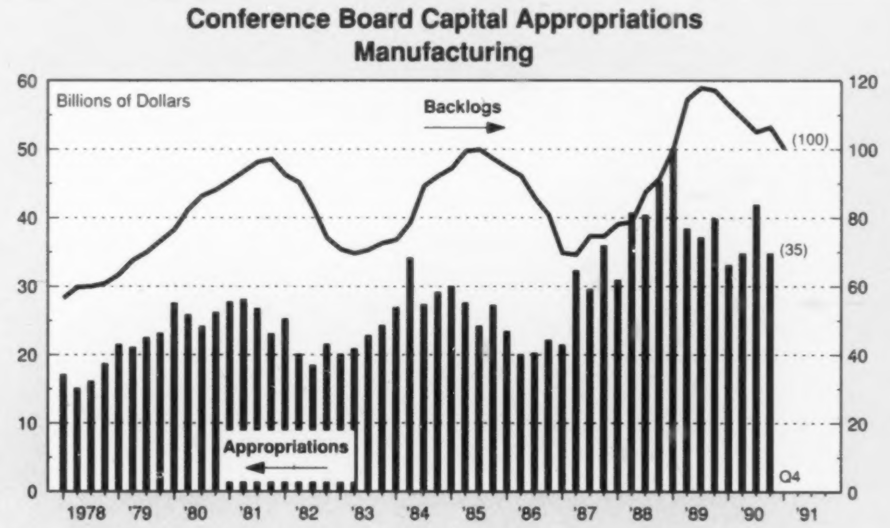


Conference Board Measure of Business Executives' Confidence

* Quarterly percent changes in GNP at annual rates

Consumers feeling good about the economy again.

Investment Intentions



Conference Board Capital Appropriations Manufacturing

Appropriations holding up better than expected.

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Date of Forecast		Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.	Apr.		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
		%	%	%	%	%	%	%	%	%	%	%		
Actual	1990 3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q 1990	Actual
	4Q	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-2.0	4Q	
Forecast	1991 1Q	-2.9	-2.3	-2.0	-2.9	-2.5	-1.2	-2.0	-3.1	-2.3	-0.5	-0.9	1Q 1991	Forecast
	2Q	-0.5	-0.4	-0.1	0.6	1.6	2.3	3.4	1.1	0.5	3.6	1.5	2Q	
	3Q	2.4	0.4	2.7	3.3	3.3	2.6	5.6	2.8	4.3	4.2	3.0	3Q	
	4Q	3.6	3.1	3.0	3.2	3.3	1.6	4.7	2.5	3.5	3.2	2.8	4Q	
	1992 1Q	4.1	3.0	3.1	1.9	3.1	2.4	2.7	3.2	3.5	3.2	2.9	1Q 1992	
	2Q	4.8	3.0	3.5	2.2	3.4	1.8	1.5	3.2	3.6	3.2	3.3	2Q	
	3Q	3.7	3.0	3.9	2.8	3.3	2.2	2.6	2.8	2.5	3.2	3.7	3Q	
	4Q	1.7	3.1	3.7	2.0	3.1	2.4	2.8	2.2	1.7	2.6	3.6	4Q	
	1993 1Q	1.9		3.6			2.4	3.1	2.9	2.4	2.9		1Q 1993	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.4	4.2	3.6	3.9	4.1	4.3	2.8	3.1	3.1	3.3	3.8	1991 4Q	Forecast
	1992 4Q	2.9	3.7	3.9	4.1	3.9	4.6	2.7	2.8	3.2	3.0	3.6	1992 4Q	

30-Yr Treasury Bond Rate

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Actual	1990 3Q	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	3Q 1990	Actual
	4Q	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	4Q	
Forecast	1991 1Q	8.1	8.2	8.2	8.1	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	Forecast
	2Q	8.0	8.1	7.9	8.1	8.2	8.1	8.3	8.0	8.3	8.3	8.1	2Q	
	3Q	8.0	8.2	7.6	8.3	8.1	8.3	8.6	7.8	8.5	8.5	8.1	3Q	
	4Q	8.1	8.3	7.6	8.4	8.1	8.6	8.6	7.7	8.8	8.6	8.0	4Q	
	1992 1Q	7.9	8.3	7.7	8.2	8.2	8.6	8.6	7.8	8.9	8.8	8.0	1Q 1992	
	2Q	7.8	8.5	7.8	8.2	8.3	8.6	8.6	7.7	9.1	8.8	7.9	2Q	
	3Q	8.2	8.7	7.9	8.4	8.4	8.6	8.8	6.3	9.0	8.9	7.9	3Q	
	4Q	8.5	8.8	7.9	8.6	8.5	8.6	8.8	6.2	9.0	9.0	7.9	4Q	
	1993 1Q	8.7		8.0			9.1	8.8	6.0	8.9	9.0		1Q 1993	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Actual	1990 4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q 1990	Actual
Forecast	1991 1Q	6.5	6.5	6.5	6.4	6.4	6.5	6.5	6.4	6.5	6.5	6.5	1Q 1991	Forecast
	1991 4Q	7.1	6.9	6.8	6.9	6.5	6.8	6.6	6.8	6.7	6.3	6.7	4Q 1991	
	1992 4Q	5.9	6.5	6.1	6.2	6.1	6.4	6.5	6.2	6.1	5.8	6.3	4Q 1992	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
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additional mailing offices

Statistical Reference Index
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Bethesda, MD 20814

R4105-80A

The Conference Board

Volume 2, Number 6 June 1991

Economic Times

INSIDE:

- **How We Spend Our Time** *(pages 6-7)*
- **Colloquium on Health Care Costs** *(page 3)*
- **International Economic Outlook** *(pages 4-5)*
- **Stat File and Crystal Ball** *(pages 8-11)*

Serving Business and Society for 75 Years

Editor's Note

Our Colloquium steps out of the usual pattern this month, in that three of its four contributors are not members of the regular colloquium panel. We are grateful to them for tackling health-care costs, one of the most serious economic issues of our time. In the next issue of *Economic Times*, the same group will focus on the question of access to medical insurance.

In this month's issue we avail ourselves of the broad review of the global economic outlook by two veteran analysts from Bechtel. And we also get a brief look at a fascinating study made at Michigan's Institute for Social Research about how the people of different nations use their time.

Ed Fiedler

Maxim of the month:

A paranoid is a man who knows a little of what's going on.

William Burroughs

Miracle in Mexico?

A brief trip South of the Border recently provided an opportunity to catch up with the dramatic economic turnaround taking place in Mexico. After three highly satisfactory decades, the Mexican economy became a shambles in the 1980s. Starting in 1988, however, a remarkable recovery got underway. Economic growth has resumed. The inflation rate has been reduced from 159 percent in 1987 to about 17 percent this year. Real interest rates have come down sharply. Foreign investment is flowing into the country in large volume again. Most important, the Mexican people are beginning to regain faith in their economy and their government. Domestic investment is climbing smartly and the "flight capital" of the early 1980s is being brought home. Many analysts are calling it an economic miracle.

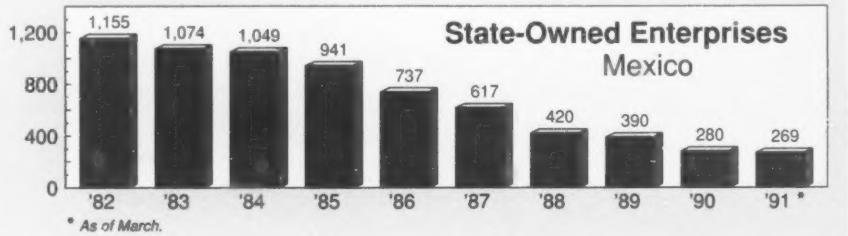
How did it all happen? It started with the indulgent and irresponsible government policies in the 1970s. The rise in oil prices, and much more, was squandered in wasteful government spending, subsidies, industry nationalizations and regulatory excesses. Mexico simply tried to live beyond its means.

The chickens came home to roost starting with the worldwide recession of the early 1980s. The difficulties were made to seem even worse by the unavoidably bitter medicine prescribed by President de la Madrid. Then in 1986 world oil prices collapsed. Both Madrid and his successor, President Salinas, however, persisted with highly disciplined economic policies: They have stripped away burdensome regulations, opened the economy internationally, reduced government spending sharply — from 45 percent to 30 percent of GDP — cut the federal deficit from 17 percent to 2 percent of GDP, and engineered a massive divestiture and liquidation of state-owned companies *(see chart)*. The payoff from these tough-minded policies appears promising.

How heavy were the costs? Draconian! Despite the recovery of 1988-91, the average manufacturing wage (adjusted for inflation) is still 2 percent below the level of a decade ago, and the minimum wage remains a shocking 52 percent lower. On average, the standard of living is still more than 10 percent below 1981.

The recovery is, therefore, far from complete, as is the reform of policy. Eleven percent of prices continue to be controlled by the government. Privatization still has a considerable way to go, including banking and steel. Inflation remains unacceptably high. But despite the reform that remains, the important story is how much has been achieved.

Is this a **miracle**? Probably not. Nevertheless, the turnaround of the Mexican economy is an extraordinary accomplishment, and we should tip our sombreros to Señors de la Madrid and Salinas. It's difficult to think of any other nation that has dealt as effectively with such a severe economic crisis. Latin America and Eastern Europe, take note!



* As of March.

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to *Economic Times*, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
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Colloquium: Health Care Costs

Background:

Health care now absorbs 12 percent of national income in the United States, a share already larger than most other nations, and rising relentlessly. Most of the increase represents rising costs per service rather than a larger quantity and quality of medical treatment. This seemingly inexorable trend frightens everyone who pays the bills, meaning almost everyone.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation. For this special topic (and next month's) we have added Henry Aaron, Director, Economic Studies Program, The Brookings Institution; Victor Fuchs, Henry J. Kaiser, Jr. Professor, Stanford University; and Walter J. McNerney, Professor of Health Policy, Northwestern University.

Question:

What are the most important changes that should be made to curb the rising cost of health care?

Henry J. Aaron
The Brookings Institution

Rising costs reflect the interaction between rapid scientific advance and a reimbursement system that is essentially open-ended because most patients are fully insured. No developed country exposes patients to significant financial costs. Controlling growth of health care outlays hinges on the creation of a budget constraint on hospitals. The solution is the imposition by a single payer of fixed budgets on hospitals and the denial of reimbursement for costly procedures outside the hospital setting.

Walter J. McNerney
Northwestern University

Mild measures to curb costs haven't worked. We need tougher measures to: Change perverse incentives (e.g., limit tax deductions for employees and stop paying for units of care on a fee basis). Put limits on what we will pay up front (e.g., capitate managed care). Control the number and special distribution of physicians (with a need for more primary physicians). And exert tighter constraints over capital and technology. The health market is weak at best. It needs more potent buyer and regulatory inputs.

Victor R. Fuchs
Stanford University

The U.S. should reduce the number of medical and surgical specialists, limit expansion of hospital facilities, and access more carefully the pace and character of technologic innovations. Additional savings should be sought in simplifying our system of finance and reimbursement and in the development and diffusion of cost-reducing technologies. Large buyers of medical care should use their bargaining power to eliminate any excess profits in the pricing policies of firms supplying the health care industry.

John T. Dunlop
Harvard University

To contain health care costs, which have been growing faster than the economy since the 1940s, the starting point is to promote fee-for-service medicine through organized medical groups. In addition we need research to define practice protocols and clinically effective care; federal pre-emption of state health insurance mandates; malpractice reform; standardized paperwork systems; education on the limits of medical intervention; and eventually a national forum to negotiate physician fee schedules and a hospital payment system.

Around the World in Eighty Nanoseconds

by Denis M. Slavich and Michael B. Selvin

D.M. Slavich

M.B. Selvin

In 1872, Phileas Fogg and Passepartout astounded the world (of fiction) by circumnavigating the globe in eighty days. At present, by contrast, when a full-day of conversation can be burst in seconds between computers in different nations, and 747s routinely move hundreds of people and tons of goods between continents in hours, the world becomes a village and all markets become local markets.

Although the phenomenon of "instant communications" may be common knowledge, its impact on the world economy is still not appreciated. Ideas, even complex technical ideas, or wrong ideas for that matter, propagate the world at the speed of light. The clearest example is market forces, which by demonstrating economic success, are overwhelming centrally planned economies. With information readily available to everyone, it is difficult for politicians to maintain the status quo in any country, especially in countries that fall short in their standard of living or lack basic freedoms.

As a result, company planning can no longer focus merely on local economies and markets with impunity. Even if the company itself is not directly involved, its executives must understand the broad trends and longer term driving forces behind current international developments. Here are some of the key trends needed to understand the international economic outlook:

Continuing World Growth. For more than two decades, there has not been a year of negative growth for the world as a whole (first chart). Despite considerable volatility and great regional variations, the world economy shows a real growth trend of about 3 percent per year since World War II. Not surprisingly, the WEFA Group predicts 3 percent annual growth for the next five years.

Large Variance By Region. The outlook for any given region may be quite different and most importantly may be quite volatile. The WEFA forecasts shown indicate a return to a healthy growth in many regions. In particular, the developing countries and the Gulf states are expected to return to strong growth, while the centrally planned economies will continue to suffer slower growth as they make the difficult transition to a more market-oriented economy.

Sound Economic Policies. There is a growing realization of the critical importance of sound economic policies. When Taiwan and the Peoples' Republic of China split in 1949, they both had a per capita GNP of about $200. Since then, Taiwan's per capita GNP has increased to about 13 times the PRC's. Similar but less dramatic conclusions can be drawn from the two Koreas and the two Germanies (second chart). Open economies with free markets have demonstrated a capacity to speed development by stimulating changes in technology, which are incorporated rapidly into the economy.

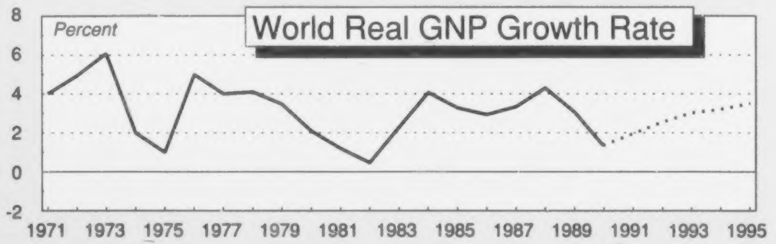
Growth Rates	*(percent per year)*		
	1970s	1980s	1990s
World	3.8	2.7	3.0
DevelopedCountries	3.2	2.8	2.8
DevelopingCountries	6.5	2.3	4.8
United States	2.7	3.0	2.1
EEC	3.1	2.2	2.9
Pacific Basin	8.1	6.5	6.9
Centrally Planned	3.9	2.9	1.4
Arabian Gulf	5.9	-0.2	4.2

Source: WEFA Group

The Nobel prize-winning economist, Robert M. Solow, identified changes in technology as a key input to growth. But note that there is a critical feedback mechanism at work here. Free markets stimulate changes in technology, and these changes are incorporated far more rapidly into economies with free market policies. The most important contributor to economic growth, itself, grows better in private economies, reinforcing the entire growth process. Today, as a consequence, economies throughout the world are opening up: goods, services, and capital, and yes, technology, are flowing more freely.

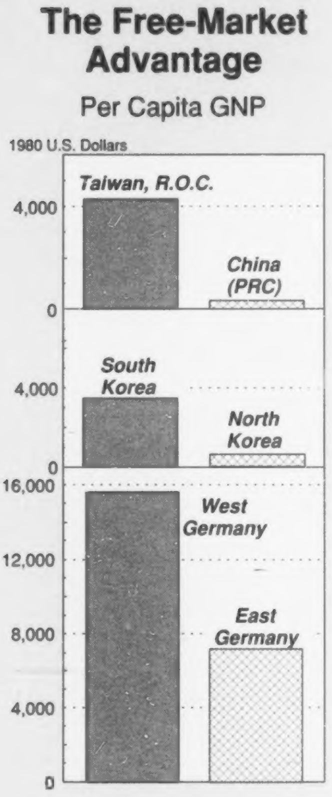
In addition to more open economies, we are seeing greater international economic integration. The first step in this direction is well established — the development of true multinational companies — companies making decisions that transcend political boundaries. The next step is the free flow of capital between countries. This flow has been accelerating, which will lead to economic integration of regions such as the EEC and the North American trading group.

The third step, or trend, then, can be thought of as the triumph of economics over politics. This trend will not be



World Real GNP Growth Rate

Source: WEFA Group



The Free-Market Advantage

Per Capita GNP

1990 data, except for Germany, 1989.
Source: WEFA Group, Fortune.

smooth however. Because the interests of politicians are generally directed at maintaining the status quo, politically motivated policies will retard or can temporarily stop the growth of market economies. When that happens, however, the costs will be high, and the people will not tolerate them for long.

Growing World Trade. World trade has demonstrated a strong secular growth trend. Although the growth of trade is highly volatile relative to GNP, it has been growing faster over the past twenty years than GNP, at a compound annual rate of over 4 percent (final chart). The U.S. experience underscores the importance of world trade. In contrast to a half-century ago, trade has become a critical element to our economy, but we do not have the power to dictate trade policies. As a result, trade has become a much more difficult political issue for the United States. In some of the European nations, trade makes up 50 percent of their GNP, and this is the direction we are headed.

Financial Flows. While most observers focus on trade, international financial flows are larger and growing more rapidly. World trade is about $4 trillion per year, or about $10-15 billion per day. By contrast, foreign exchange transactions account for $200 billion per day, or some 15-20 times annual trade volume.

The ultimate linkage among economies is foreign direct investment. Direct investment implies a true connection, based on the risks and rewards of investing in another country. Trade is indirect; investment is direct, participatory, and long-term. In the past few years, direct investment has grown faster than both trade and GNP, at an annual rate of almost 5 percent (final chart). As economic integration continues and barriers to the flow of international capital decline, this rate will increase, further integrating economies and hastening the transfer of technology.

The International Outlook

To summarize, the international outlook is positive. World GNP should grow in the 3 percent range over the next few years. Market forces will continue to enforce efficiency, even while they challenge political power and increase financial volatility.

In 1991 world growth will be positive but barely so. Approximately half the world (measured by GNP) is currently in recession, so this will be a difficult year.

The longer term is more interesting. Regional integration will continue strongly, with the EEC leading the way. The United States and Canada will continue as a trade block, with the participation of Mexico, and later others will join.

International trade will take on a greater importance to all countries, including the United States. The trend will entail globalization of manufacturing, that is, siting plants in optimum locations in relation to markets, suppliers, labor, raw materials, and government policies.

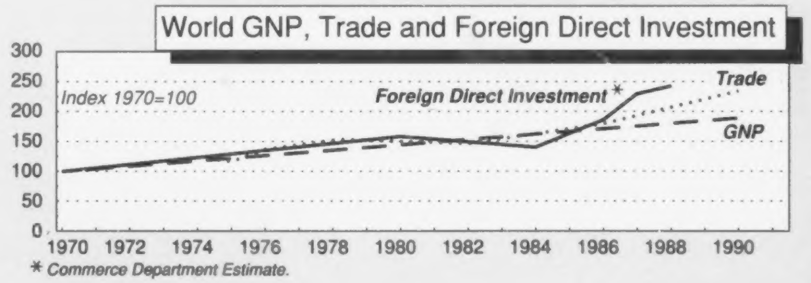
Software, communications, publishing, information, and other services are also being forced to compete on an increasingly international scale. The change in communications technology is doing to services what modern transportation technology did to trade in goods. Foreign direct investment will continue to outpace GNP and trade growth.

A country's growth prospects will depend upon how freely capital and technology flow into that country. Countries that are successful at attracting capital and technology should show growth well in excess of 3 percent. Countries that remain isolated will experience growth rates that are very low indeed.

Conclusion

When Phileas Fogg and Passepartout completed their journey, the world was suddenly a smaller place. Today, technology is accelerating the pace of change. The reward will be to those countries and companies that remain flexible and move fast, while at the same time provide for people and their needs. For even Mr. Fogg conceded he could have made the trip in 78 days by not crossing India.

Messrs. Slavich and Selvin are with the Bechtel Group, Inc. This article is excerpted from Mr. Slavich's presentation to The Conference Board's Financial Outlook Conference, February 27-28, 1991.

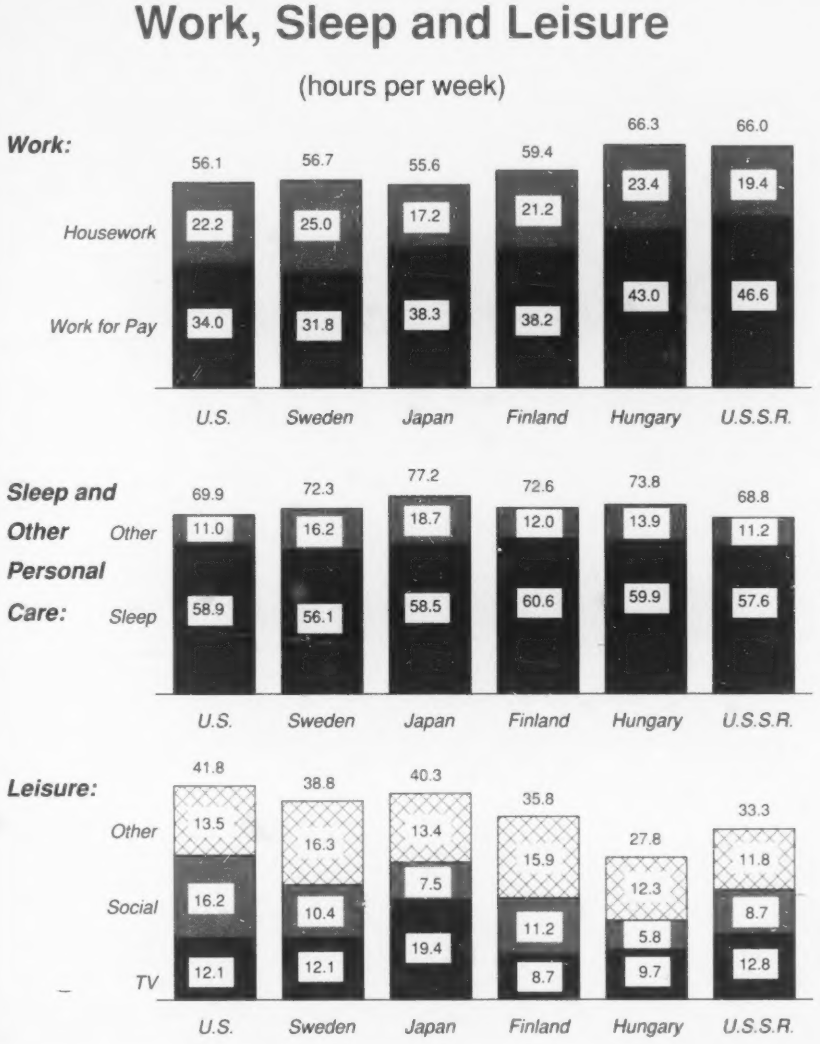


World GNP, Trade and Foreign Direct Investment

** Commerce Department Estimate.*

How Do We Use Our Time?

by F.Thomas Juster and Frank P. Stafford



Time devoted to leisure tends to be greater, and time devoted to work shorter, in the high-income countries of the United States and Sweden than is true for Hungary and the U.S.S.R. This is consistent with the principle that over the longer term some of the gains in living standards are allocated to additional leisure, rather than to still higher consumption of goods and services.

In Sweden, the fewer hours spent working for pay, especially by men, and the greater number of hours spent doing housework, support the thesis that high marginal income tax rates in that country represent a deterrent to work for pay. The authors report that detailed data show Swedish men to be the clear leaders in home-improvement time, averaging over 4 hours per week in 1984. In contrast, men in the United States averaged 2.8 hours, and Japanese men less than one hour.

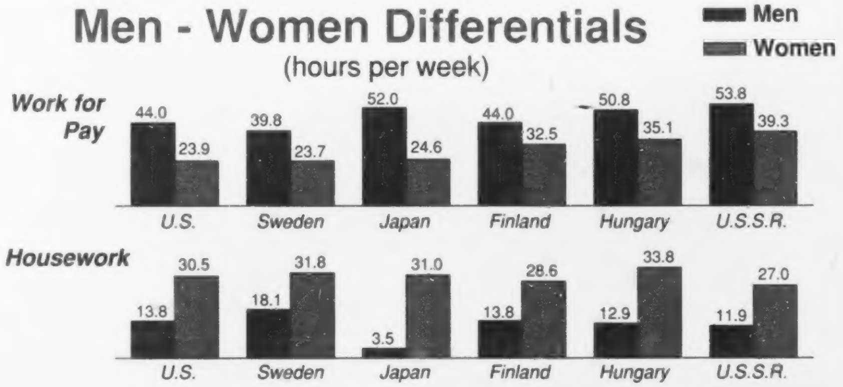
Sleeping time is, not surprisingly, very similar in all countries.

Watching television is much more prevalent in Japan than elsewhere, especially among women.

Time spent in social interaction is substantially higher in the United States than elsewhere, and is quite low in Hungary, Japan and the U.S.S.R.

Total work time (work for pay plus housework) tends to be longer for men than for women only in the higher income countries.

Housework by men (including routine chores, home projects and child care) is substantially longer than average in Sweden and strikingly low in Japan.

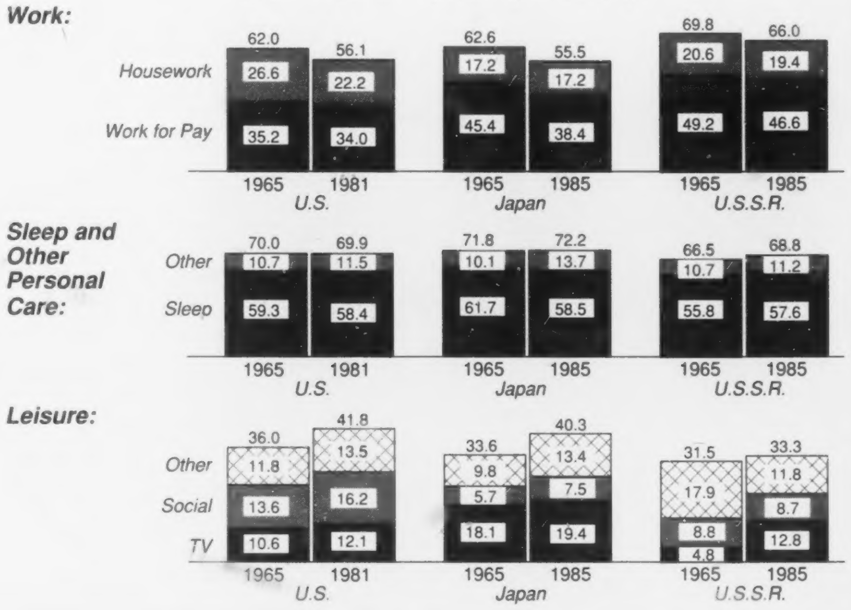


Time spent working, both for pay and in total, declined significantly in all three countries across the years.

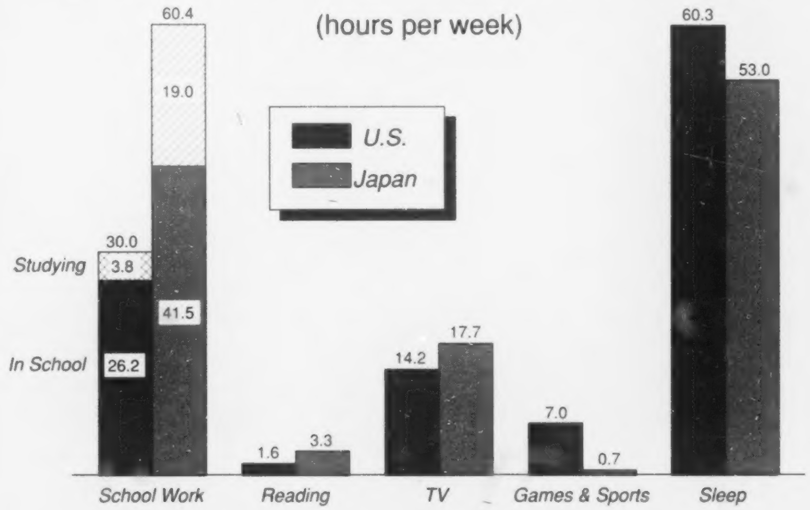
Correspondingly, time spent in leisure pursuits increased. The dramatic increase in TV viewing in the U.S.S.R. (the City of Pskov) might have reflected (we can speculate) a wider availability of TV programming becoming available during the intervening years.

Changes in How We Use Our Time

1965-1980's (hours per week)



High School Students, U.S. & Japan



The longer hours Japanese students spend on schoolwork compared to American children have been widely reported, but the extraordinary differences shown in this research — 50 percent more time in school and five times as many hours of homework — are startling indeed.

In view of the above, it is curious that Japanese high-schoolers also spend more time than their American counterparts reading and watching television.

American students devote more time to games and sports than the Japanese children do, and also spend more time sleeping. The authors also surmise that in addition the American youth spend more time "hanging around."

General Notes:

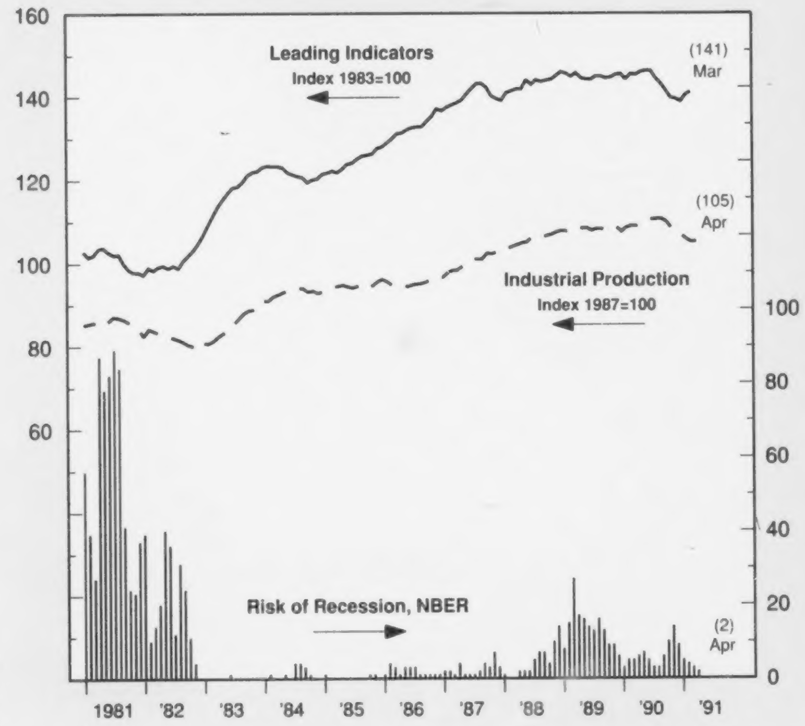
Excerpted from The Allocation of Time *by F. Thomas Juster and Frank P. Stafford, Institute for Social Research, The University of Michigan, forthcoming in the* Journal of Economic Literature, *June 1991. Data for the U.S.S.R. cover only the city of Pskov; all others are national data. Work for pay includes commuting time. "Social" represents time spent in social interaction, including visits to friends and neighbors, eating out, movies, and so forth. Hours reported in the first and third charts represent averages for adult men and women.*

Conference Board Stat File

Recovery Ahead, Slower than Normal but Better than Consensus

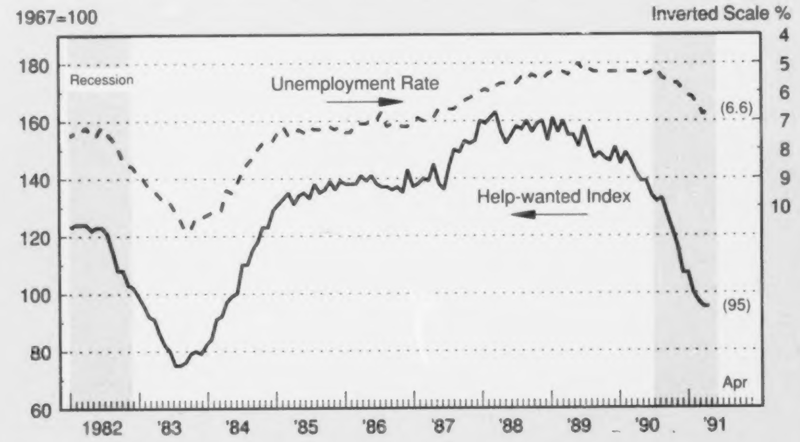
Whether the business-cycle recovery is just behind us (April/May) or just ahead (June/July) can't be determined now, but it's close enough to taste. That does not, of course, end all the bad news. When economists say the recession is over, it only means the economy has changed direction, not (as the public often interprets such a statement) that we economists think happy days are here again. The central issue is how vigorous will the recovery be? The consensus is, slower-than-normal. But that's what the consensus always calls for at this point. This time, however, there may be better reasons than usual for such a conclusion. (A greater-than-usual reluctance by the banks to extend credit, continued high real long-term interest rates, less-than-usual stimulus from the budget, and a general historical pattern that mild recessions beget mild recoveries.) I can agree with the forecast of a slow recovery but I'll put my nickel on a growth rate faster than the current consensus of 3-plus percent.

Early Warning Indicators



Cyclical recovery has started or is imminent.

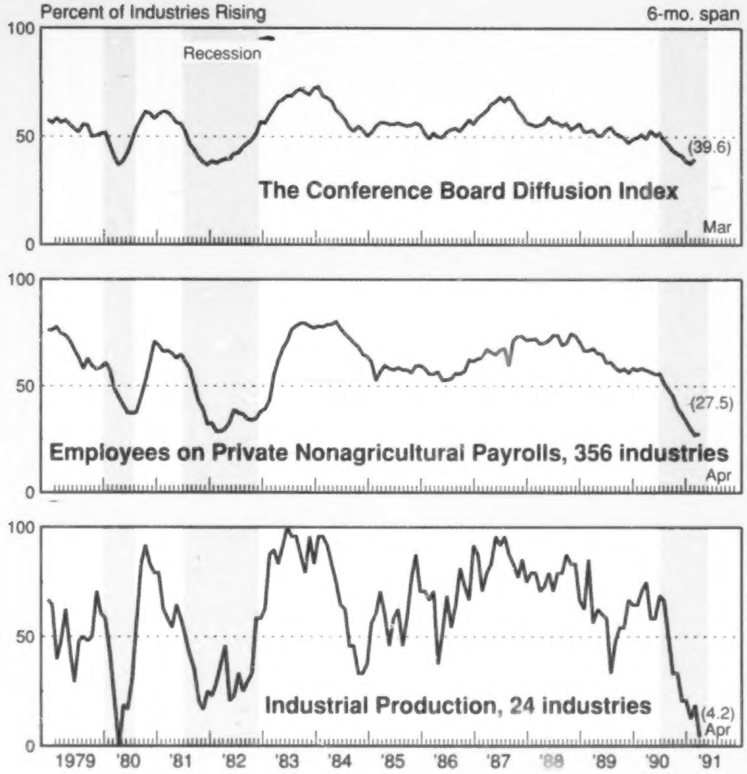
Help-wanted Advertising and Unemployment



Labor markets continue to be very weak.

Conference Board Stat File

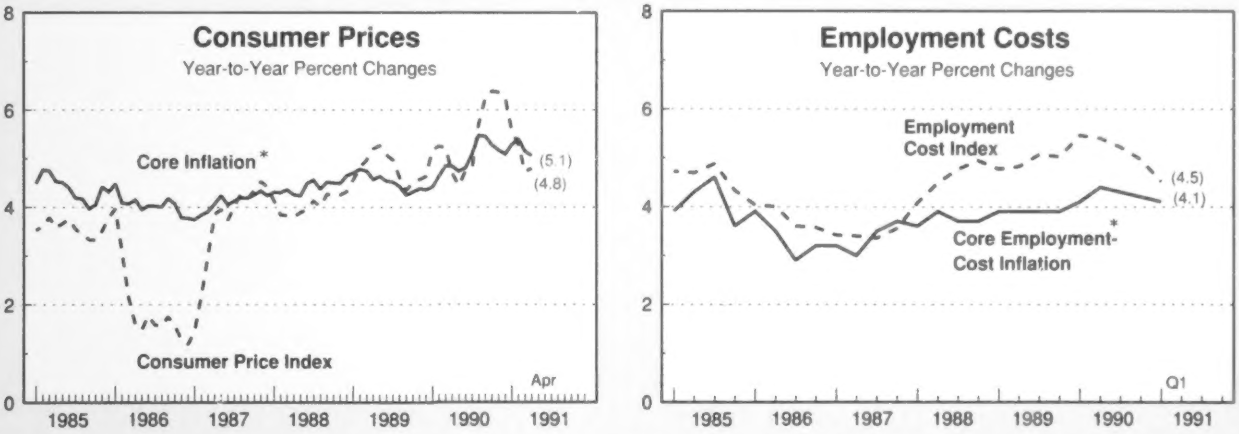
Indexes of Economic Momentum



Confirmation of rebound not found here.

Inflation indicators look a bit better, but they still show no improvement over the earlier "base" rate.

Inflation Fundamentals

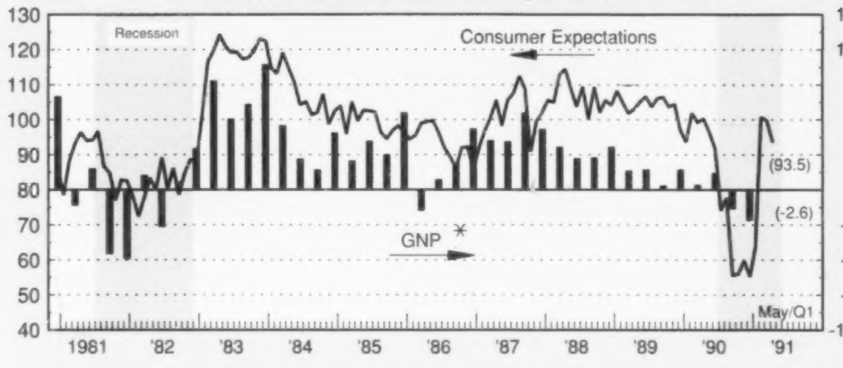


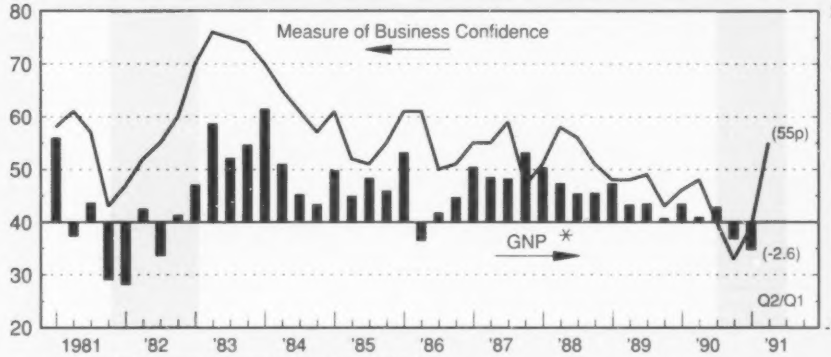
* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

Conference Board Stat File

Confidence


Conference Board Consumer Expectations Index

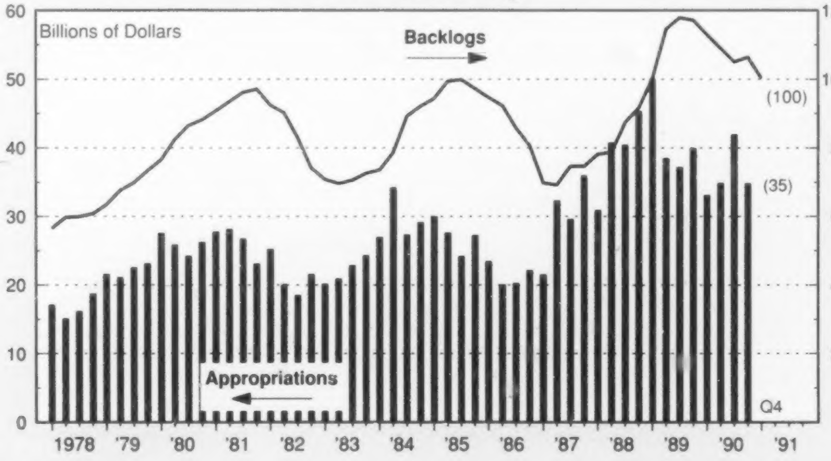

Conference Board Measure of Business Executives' Confidence

* Quarterly percent changes in GNP at annual rates

Confidence measures consistent with at least a moderate recovery.

Investment Intentions

Conference Board Capital Appropriations Manufacturing



Appropriations holding up better than expected.

Inside the Crystal Ball

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Date of Forecast		May	May	May	May	May	May	May	May	May	May	May		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		%	%	%	%	%	%	%	%	%	%	%		
Actual	1990 4Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	4Q 1990	Actual
	1991 1Q	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	1Q 1991	
Forecast	2Q	-0.5	-0.4	-1.0	-0.3	0.8	2.4	1.7	-1.0	0.2	0.8	0.6	2Q	Forecast
	3Q	2.4	0.5	2.6	2.7	3.3	2.3	3.9	1.9	3.6	3.6	2.3	3Q	
	4Q	3.6	3.1	3.5	3.2	3.3	1.6	4.5	2.6	3.4	4.5	2.5	4Q	
	1992 1Q	4.1	3.0	3.1	2.8	3.1	2.4	4.2	4.0	3.7	5.0	2.6	1Q 1992	
	2Q	4.8	3.0	3.7	2.3	3.4	1.9	2.3	3.7	3.0	4.7	2.7	2Q	
	3Q	3.7	3.0	3.9	2.7	3.3	2.2	1.8	3.3	2.4	4.4	2.9	3Q	
	4Q	1.7	3.1	3.8	1.9	3.1	2.5	2.1	2.6	2.2	3.3	2.6	4Q	
	1993 1Q	1.9		3.7			2.4	4.1	3.0	2.3	3.1		1Q 1993	
	2Q	0.8		3.6			2.2	3.5	3.0	2.9	2.3		2Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.6	4.3	4.1	4.0	4.4	4.4	3.0	4.0	3.5	3.1	3.8	1991 4Q	Forecast
	1992 4Q	2.8	3.7	3.6	3.9	4.0	4.7	2.6	2.8	3.2	3.1	3.4	1992 4Q	

30-Yr Treasury Bond Rate

Actual	1990 4Q	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	4Q 1990	Acutal
	1991 1Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	
Forecast	2Q	8.0	8.2	8.2	8.1	8.1	8.1	8.4	8.2	8.3	8.1	8.2	2Q	Forecast
	3Q	8.0	8.2	7.9	7.9	8.1	8.3	8.6	8.0	8.3	8.1	8.2	3Q	
	4Q	8.1	8.3	7.6	8.1	8.1	8.3	8.6	7.8	8.5	8.3	8.1	4Q	
	1992 1Q	7.9	8.3	7.7	8.2	8.2	8.6	8.5	7.7	8.8	8.4	8.0	1Q 1992	
	2Q	7.8	8.5	7.8	8.5	8.3	8.6	8.4	7.8	8.9	8.5	7.9	2Q	
	3Q	8.2	8.6	7.9	8.5	8.4	8.6	8.5	7.7	8.9	8.6	7.8	3Q	
	4Q	8.5	8.8	7.9	8.7	8.5	8.6	8.6	6.3	8.7	8.7	7.6	4Q	
	1993 1Q	8.7		8.0		8.6	9.1	8.7	6.2	8.7	8.8		1Q 1993	
	2Q	8.9		8.0			9.1	8.5	6.0	8.6	8.9		2Q	

Unemployment Rate

(Percent, quarterly)

Actual	1990 1Q	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	1Q 1990	Actual
Forecast	1991 4Q	7.1	6.9	6.6	6.8	6.9	6.9	7.0	7.3	6.9	6.3	6.8	4Q 1991	Forecast
	1992 4Q	5.9	6.5	6.2	6.6	6.5	6.6	6.6	6.4	6.3	5.4	6.7	4Q 1992	
	1993 2Q	5.9		6.0			6.4	6.4	6.1	6.2	5.4		2Q 1993	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
and at
additional mailing offices

Statistical Reference Index
Acquisitions
4520 East West Highway
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Bethesda, MD 20814

R4105-80A

The Conference Board

Volume 2, Number 7 July / August 1991

Economic Times

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- **A Challenge to the Professional Pessimists** *(pages 4-5)*
- **Why is Immigration Like the 1947 Dodgers?** *(pages 6-7)*
- **Colloquium Looks at Health Insurance** *(page 3)*
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Serving Business and Society for 75 Years

Editor's Note

This month we again offer our quarterly round-up on the outlook for various industries — see the shaded center section — prepared by specialists in each of the industries.

On the following page our special Colloquium panel on health care tells us what needs to be done about the many Americans who lack adequate insurance.

Next, we get a historical rundown on the parallel paths through the centuries taken by progress and pessimism. And then Julian Simon analyzes the often overlooked benefits of immigration.

See you all next in September. Meanwhile, have a good summer.

Ed Fiedler

Maxim of the Month

In forecasting, give 'em a number or give 'em a date, but never both.

Attributed to Sir Alec Cairncross

Anemic? Or Vigorous? Yes!

With most analysts now agreeing that the 1990-91 recession has ended, forecasters have turned their attention to the vigor of the recovery. That debate is more interesting than most — analytically somewhat richer than usual, and for once it seems the arguments are, except (as usual) for the yellow-dog business journals, being conducted in a more gracious manner.

There are persuasive arguments on both sides. The consensus forecast calls for a growth rate of about 3 percent from mid-'91 to mid-'92. Only a few hardy optimists are projecting a cyclical recovery equal to the 6-percent historical norm — the average pace of recovery following the eight recessions since World War II.

But the optimists make some strong arguments. Perhaps the best is history, the fact that during the first 18-24 months almost every cyclical recovery since World War II has recorded a growth rate in the neighborhood of 6 percent. In addition, there are at least three important sectors of the economy with good credentials for a strong rebound: First, consumption, where the surveys of expectations have rebounded very encouragingly; second, exports, where the depressed international exchange value of the dollar — yes, still low, even after the run-up this spring — puts U.S. producers at a substantial competitive advantage in world markets (see Stat File comments, p.8, and chart, p.10); and third, inventories, which despite being kept under good control before the downturn have been liquidated heavily during the recession, suggesting the need for some very substantial re-stocking during the recovery.

Those who forecast a slower recovery make a good case, too. They note, first, that the demographics are a lot less favorable than a decade ago — 1.4 million new households are expected to be formed this year, in contrast to 1.9 million in the early 1980s. Second, real interest rates on bonds and other long-maturity borrowings remain high, dampening the outlook for housing, heavy construction and other interest-sensitive activities. Third, contrary to the usual practice, federal taxes have not been cut and federal spending has not been boosted to help stimulate the recovery.

Fourth, the 1990-91 recession was a mild one, and past experience tells us that mild recessions tend to beget milder than average recoveries. Finally, and perhaps most important, there is the fact that most of the history from which the 6 percent average recovery is calculated was recorded back when the underlying productivity trend was pushing 3 percent per year, rather than the 1 percent rate that has characterized the past two decades. What this suggests is that before we use the historical average as a norm we probably ought to reduce it by a couple of percentage points. If we don't, a "normal" recovery is going to exceed the economic speed limit and, after a year or so, generate a new upsurge of inflationary pressures. Which, no thank you, we very much do not need.

Who's going to win this argument? How vigorous will this recovery prove to be? My guess is still that it'll be stronger than consensus but short of the historical norm. But let's not forget the only honest answer to that question: **Nobody knows!**

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to *Economic Times*, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium: Health Care Insurance

Background:

Although most Americans receive competent health care the costs of which are covered by health insurance, about 33 million of us live without that basic security, and tens of millions more are inadequately covered. Further, anecdotal evidence suggests that for many families insurance is becoming very difficult to obtain even at much higher prices.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation. For this special topic we have added Henry Aaron, Director, Economic Studies Program, The Brookings Institution; Victor Fuchs, Henry J. Kaiser, Jr. Professor, Stanford University; and Walter J. McNerney, Professor of Health Policy, Northwestern University.

Question:

What should be done to make health insurance available to those not now covered?

Henry J. Aaron
The Brookings Institution

All methods of achieving universal financial access to health care have serious flaws. The "worst system except for all the others" and therefore the best is to make employment-based insurance mandatory and extend public coverage beyond medicare and Medicaid to everyone not connected to families with a member in the labor force. Major alternatives, such as immediate adoption of national health insurance or tax-credit based schemes, involve enormous institutional disruption and income redistribution.

Walter J. McNerney
Northwestern University

Given federal budget targets and the lack of enthusiasm among voters to spend more, we will have to settle for incremental steps. A place to start would be to mandate a minimum benefit package for most employers, with provision for tax breaks for small employers. Also, we should institute a federal/state program focused on the mother and child. To ignore such steps much longer will leave our credibility as a humane society in serious doubt throughout the world.

John T. Dunlop
Harvard University

Initially a specified basic benefit package is required, followed by access steps phased with tough cost constraints. First, reform the insurance market for small business to preclude selecting-out high risks. Second, provide tax credits to small business. Third, eliminate state mandates of insurance beyond a basic package. Fourth (later), federalize Medicaid with a buy-in for the unemployed. Fifth (eventually), require purchase or provision of a basic benefit package from regional funds administered by private insurers selected competitively.

Victor R. Fuchs
Stanford University

Universal coverage requires two things. First, the government must use compulsion for those unwilling to obtain insurance voluntarily (i.e., gamblers and "free riders"). Second, the federal government should use general revenues to substitute premiums for the poor and for the non-poor who face abnormally high premiums because of bad health. Existing patterns of insurance distribution should be tried first. If they prove to be unsatisfactory, government-sponsored national health insurance would be necessary.

Progress and Pessimism

by Dwight Lee

The only thing more persistent than progress is pessimism about further progress. Ever since the Industrial Revolution, we have experienced a widespread increase in material well-being, life expectancy, and leisure that literally could not have been imagined three centuries ago. Yet, this enormous progress is still accompanied by a steady stream of forecasts predicting impending crises and the end of progress.

Time magazine, for example, introduced its cover story on the "Endangered Earth" with a statement that mankind "may have no alternative to the bang of nuclear holocaust or the whimper of slow extinction." Senator Albert Gore, Jr., warns that "...we are being drawn toward the brink of ecological collapse." Brazil's Secretary of the Environment, Jose Antonio Lutzenberger, said "...the idea of sustainable growth is a contradiction in terms." And environmental activist Barry Commoner claims that "the ecosphere...is likely to end in global catastrophe."

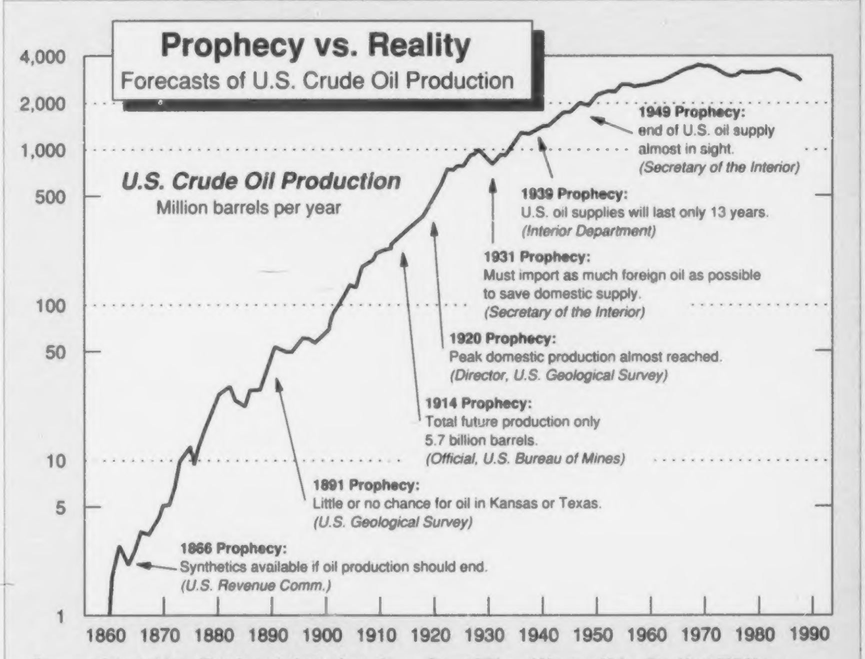
False Prophecies from the Past

Such pessimistic assessments of the prospects for progress are part of a long tradition of despair. One of the earlier, and best known, purveyors of gloom was Thomas Malthus, who in 1798 predicted that starvation and pestilence would limit the size of a population destined to a perpetual existence of bare subsistence. Another well-known English economist, William Stanley Jevons, wrote in 1865 that the exhaustion of coal supplies would soon bring industrial progress to a halt.

At the beginning of the present century, expert opinion was convinced that the supply of wood in the United States would soon be exhausted. As the *New York Times* headline put it: "Hickory Disappearing, Supply of Wood Nears End — Much Wasted and There's No Substitute" (October 31, 1908). And, as the chart shows, the experts have had us about to run out of oil almost from the time it began to be widely used.

Some of the most prestigious scientists in the past dismissed the possibility of innovations and advances in knowledge that today we take for granted. The British Royal Society responded to Thomas Edison's proposals by issuing the statement that Edison's ideas to electrify cities "defy scientific principle" and "wouldn't work." Lord Kelvin, President of the Royal Society, informed people in 1895 that "heavier-than-air flying machines are impossible." Charles H. Duell, who was the Director of the U.S. Patent Office, is quoted as saying in 1899 that "everything that can be invented, has been invented." Robert Millikan, a Nobel Prize winner in physics, stated in 1923 that "there is no likelihood man can ever tap the power of the atom."

Fortunately, creativity has never been respectful of expert opinion. Human progress is a history of the discovery of ingenious ways around, over, and through the obstacles that have stood in the way of our desire for greater material well-being. When man's natural creativity and persistent discontent are coupled with the incentives and information of the marketplace, we have a powerful correlation of forces pushing for progress.



Prophecy vs. Reality

Forecasts of U.S. Crude Oil Production

Sources: Adapted from Petroleum Independent, *Nov. - Dec. 1972, and Herman Kahn,* The Next 200 Years

Numerous examples of the expansion of the economy's useful resource base could be cited. Possibly the most obvious example in recent years is the computer. Consider the now almost prosaic use of computers to allow people to telecommute; to work with the same effectiveness at home as at the office. It has been estimated that if 12 to 14 percent of urban commuting is replaced by telecommuting, the annual reduction in U.S. petroleum consumption would come to 75 million barrels. Sand and knowledge combine to make the silicon chips that are the heart of computers which, in essence, become substitutes for petroleum.

While seldom recognized, and certainly underappreciated by those who are most vocal in their concern for our forests, chemicals are currently a major substitute for wood products. According to former Chairman of the Atomic Energy Commission, Dixy Lee Ray, "Through the use of wood preservatives in pressure-treated lumber for fences, porches, decks, and homes, we have saved a forest of trees two times the size of New England."

Other breakthroughs may expand the useful resource base beyond our current dreams. Recent advances in superconductors suggest the possibility of substituting ceramics for electricity production. With likely breakthroughs in nuclear fusion, sea water could become an inexhaustible source of energy by the next century.

Artificial Crises and Economic Progress

Despite the long history of market responses straight-arming one crisis after another, and the more recent history of government suppression of market responses perpetuating one crisis after another, the presumption is that a crisis calls for government solution. And if a real crisis is not available, an artificial crisis created by distortions and misinformation will serve just as well.

Consider the statements of some of those who hold themselves up as environmental experts. According to Richard Benedick of the U.S. State Department, while on assignment with the Conservation Foundation, "A global climate treaty must be implemented even if there is no scientific evidence to back the greenhouse effect." Stephen Schneider, a highly publicized environmental activist, states. "[W]e have to offer up scary scenarios, make simplified, dramatic statements, and make little mention of any doubts we may have. Each of us has to decide what the right balance is between being effective and being honest." Senator Timothy Wirth of Colorado has said, "We've got to ride the global warming issue. Even if the theory of global warming is wrong, we will be doing the right thing anyway, in terms of economic policy and environmental policy."

A brief look at some of the predictions of those who want to protect us against economic progress makes clear that indeed they are more interested in being effective (at creating artificial crises) than in being honest. One of the most absurd, but widely read and regarded, examples of the predicted end of progress is contained in the 1972 Club of Rome report, *The Limits to Growth*. They concluded that the only thing that could save civilization from collapse and ruin by the end of the twenty-first century was the immediate halt to economic progress.

At least the authors of *The Limits to Growth* were smart enough to make a prediction that extended beyond their lifetimes. Stanford biologist Paul Ehrlich cannot be accused of such a prudent approach. In the 1960s, Ehrlich informed us in his book, *The Population Bomb*, that sometime in the 1970s global famine would result in the starvation of hundreds of millions of people. As the end of the 1970s approached with per capita world food production increasing, Ehrlich decided it was time to adjust his prediction. The year 1985 was picked for the global famine. Not discouraged by the problem of timing, Ehrlich now proclaims that by the year 1999 over 90 percent of the U.S. population will perish because of famine and global warming. Ehrlich has been rewarded for his special prescience by being hired as a regular commentator for NBC television. There can be no doubt that many of the doomsayers have developed a vested interest in their predictions.

Conclusion

In the past, fears of a crisis were not likely to be widespread unless the crisis was real. Today, mass media and massive government can create crises out of little more than exaggerated rhetoric. In response to fears fomented and exploited by environmental extremists with media access, government action can, and often does, convert an artificial crisis into the real thing by mandating prohibitions, protections, and price controls that immobilize market responses.

Environmental extremism is, and will remain, a potential source of disruption. We should not give the extreme environmentalists credit for more power than they have, however, by succumbing to unfounded fears. Both history and economic analysis inform us that the forces propelling economic progress are powerful ones. In the absence of overreaching government responses to public fears, the combination of market incentives and human ingenuity create a momentum for progress that is too strong to be derailed by those whose primary energy comes from a naive longing for the end of progress.

Excerpted from *The Perpetual Assault on Progress*, May 1991, Center for the Study of American Business, Washington University in St. Louis. Dwight Lee is the Ramsey Professor of Economics at the University of Georgia and an adjunct fellow of the Center for the Study of American Business.

Immigration and Branch Rickey's Vision

by Julian L. Simon

Increasing the flow of immigrants presents the United States with an opportunity to realize many national goals with a single stroke. It is a safe and sure path — open to no other nation — to achieve all of these benefits:

- A sharply increased rate of technological advance, spurred by the addition of top scientific talent from all over the world.
- Satisfaction of business's demand for the labor that the baby-bust generation makes scarce.
- A lessening of the burden that retirees impose upon the ever-shrinking cohort of citizens of labor-force age, who must support the Social Security System.
- Rising tax revenues — resulting from the increase in the proportion of workers to retirees — that will provide the only painless way of shrinking and perhaps even eliminating the federal deficit.
- Improvement in our competitive position vis-à-vis Japan, Europe, and the rest of the world.
- A boost to our image abroad, stemming from immigrants' connections with their relatives back home, and from the remittances that they send back to them.
- Not least, the opportunity given to additional people to enjoy the blessings of life in the United States.

All the U.S. need do to achieve these benefits is further to relax its barriers against skilled immigrants. Talented and energetic people want to come here.

We tend to think of ourselves as a "nation of immigrants," but less than one out of fifteen people now in the U.S. was born abroad. The recent flow is less than a fourth as heavy as it was between 1901 and 1910. We are a nation not of immigrants, but rather of the descendants of immigrants.

Malthusian and Other Objections

Now let us consider the costs and benefits of immigration — even though economic issues may not be the real heart of the matter, often serving only as a smoke screen to conceal the true motives for opposition. The first objection — the "Malthusian objection" — is the idea that immigration dilutes the amount of capital per worker, which causes output per worker to fall. Nowadays, however, the most important capital is human capital — education and skills, which people own themselves and carry with them — rather than capitalist-supplied physical capital. Human capital is far more important in a country's development. And immigrants supply their own human capital.

Nowadays human capital — education and skills — is far more important than physical capital in a country's development. And immigrants supply their own human capital.

The second objection, the one that most captures the public's imagination, is welfare payments. In an analysis of Census Bureau data I found that, aside from Social Security and Medicare, about as much money is spent on welfare services and schooling for immigrant families as for citizens. When programs for the elderly are included, immigrant families receive far **less** in public services than natives. And U.S. immigrants pay much more in taxes than they receive in benefits.

Some cities and states with disproportionately high immigration do incur significant costs and complications when immigrants first arrive. Perhaps the cities should get more federal assistance. The taxes paid by the immigrants to the federal government will later more than offset this transfer to the cities.

The third and most dramatic argument against immigration has been that foreigners take jobs held by natives and thereby increase native unemployment. In the shortest run, additional immigrants in a given occupation must to some degree lower wages and/or increase unemployment in that occupation. But because immigrants come with a variety of skills, workers in most occupations feel little impact.

A good-sized body of competent recent research shows that immigration does not exacerbate unemployment, even among directly competing groups. The explanation is that immigrants not only take jobs, but also create them. Their purchases increase the demand for labor, leading to new hires roughly equal in number to the immigrant workers. Immigrants also create jobs directly by opening new small businesses — which are the main generator of new jobs in the economy — in larger proportion than do natives.

(continued on p. 7)

Ellis Island, Historic Gateway for U.S. Immigrants.

Illustration by T. O'Brien Slater.

Boosting Productivity

Most important in the long run is the boost that immigrants give to productivity. Some of the productivity increase comes from immigrants working in industries and laboratories that are at the forefront of world technology. Remember that the development of the atomic bomb hinged on the participation of such immigrants as Enrico Fermi, John von Neumann, and Stan Ulam. Contemporary newspaper stories continue this historical saga, noting the disproportionate numbers of Vietnamese and other Asian immigrant youths who achieve distinction in competitions such as the Westinghouse Science Talent Search. Ben Wattenberg and Karl Zinsmeister of the American Enterprise Institute write that among the 40 1988 finalists, "22 were foreign-born or children of foreign-born parents from Taiwan, China, Korea, India, Guyana, Poland, Trinidad, Canada, Peru, Iran, Vietnam and Honduras."

The Real Reasons for Opposition

There are various reasons for our failure to take in more immigrants, despite the clear-cut benefits of doing so. The first is ignorance of the benefits described above. Second is the opposition by special interests, such as organized labor (which wants to restrict competition for jobs) and ethnic groups (whose members often fear that immigration will cause their proportion of the population to decrease). The third reason is well-organized opposition to immigration and total lack of organized support for it.

> *Another check to immigration is nativism or racism, a motive that often lies beneath the surface of the opposition's arguments.*

The fourth check to immigration is nativism or racism, a motive that often lies beneath the surface of the opposition's arguments. Rita Simon of American University who has studied the history of public opinion toward immigrants has found that the arguments against immigration have remained eerily identical.

In the first half of the nineteenth century Irish immigrants in New York and Boston were seen as the unassimilable possessors of all bad qualities. The 1884 platform of the Democratic party stated its opposition to the "importation of foreign labor or the admission of servile races unfitted by habit, training, religion or kindred for absorption into the great body of our people or for the citizenship which our laws confer." In the 1920s the *Saturday Evening Post* also directed fear and hatred at the "new immigrants" from Southern and Eastern Europe: "More than a third of them cannot read and write; generally speaking they have been very difficult to assimilate."

Today many people still privately sympathize with such views.

Political Advantages

Political power and economic well-being are intimately related: a nation's international standing is heavily influenced by its economic situation. And today the future of any country depends entirely on its progress in knowledge, skill and productivity. That's why immigration safely, cheaply, and surely provides the U.S. with perhaps the greatest opportunity that a country has ever had to surpass its political rivals.

Immigration policy presents the U.S. with an opportunity like the one that faced the Brooklyn Dodgers in 1947, before blacks played baseball on any major-league team. Signing Jackie Robinson and then Roy Campanella, at the price of antagonizing some players and club owners, put the Dodgers way ahead of the pack. In the case of immigration, unlike baseball, no other "team" can duplicate our feat, because immigrants mainly want to come here. All we need are the vision, guts, and ambition of Dodger general manager Branch Rickey.

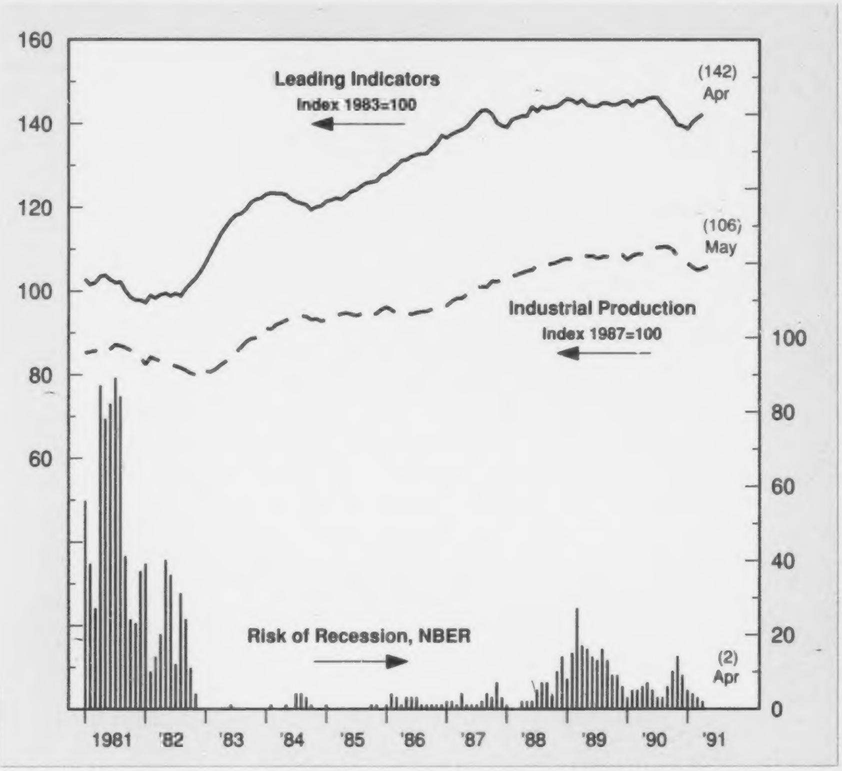
Excerpted from "The Case for Greatly Increased Immigration," *The Public Interest*, Winter 1991. Julian L. Simon is Professor of Business Administration at the University of Maryland, and the author of *The Economic Consequences of Immigration* and, most recently, *Population Matters: People, Resources, Environment and Immigration.*

Conference Board Stat File

Robust U.S. Competitive Position

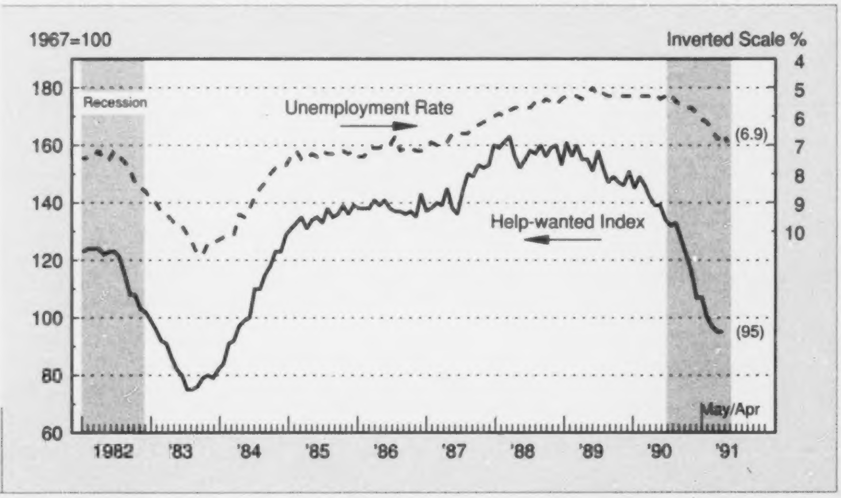
The new data in our Stat File this month strongly affirm that the cyclical upturn is now behind us, but do not otherwise enlighten us meaningfully about the economy. We've added one new chart (p.10, bottom) courtesy of Morgan Stanley Economic Research. This chart provides an alternative way of showing how favorably or unfavorably a country's competitive position has been treated by the international currency markets. What these data show is how difficult it is at present for foreign manufacturers to compete against American producers. The dollar has been so low, in fact, that on average foreigners are incurring losses on imports to the United States. As Robert Gay of Morgan Stanley put it, "...U.S. producers should be able to maintain or even to increase their share of the world's production of tradable goods." *(Note: data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Change in cyclical direction seems almost assured.

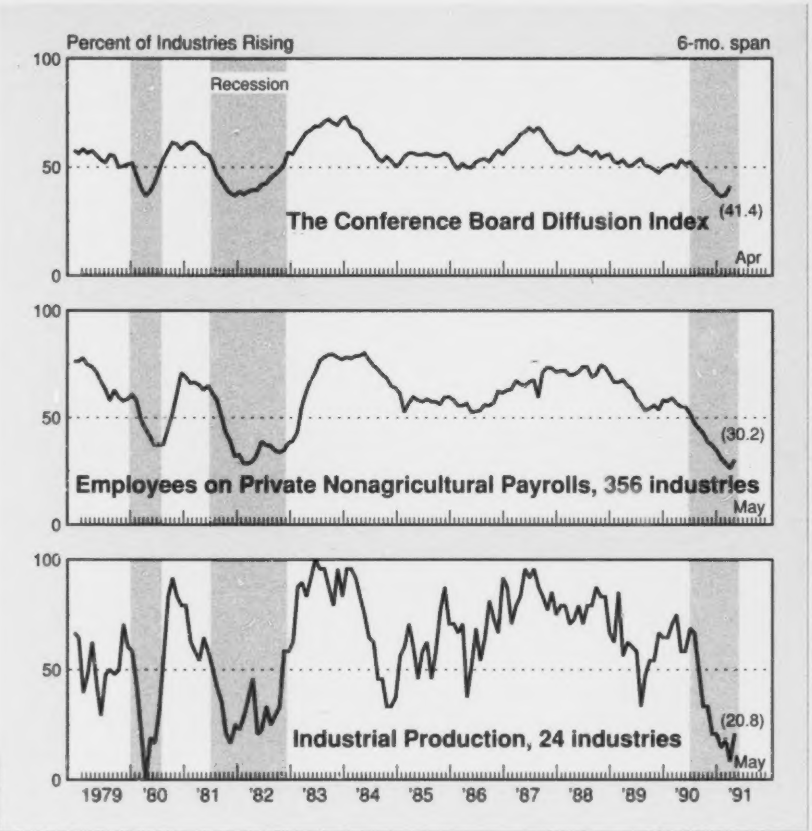
Help-wanted Advertising and Unemployment



As usual, labor market indicators slow to turn at the end of recession.

Conference Board Stat File

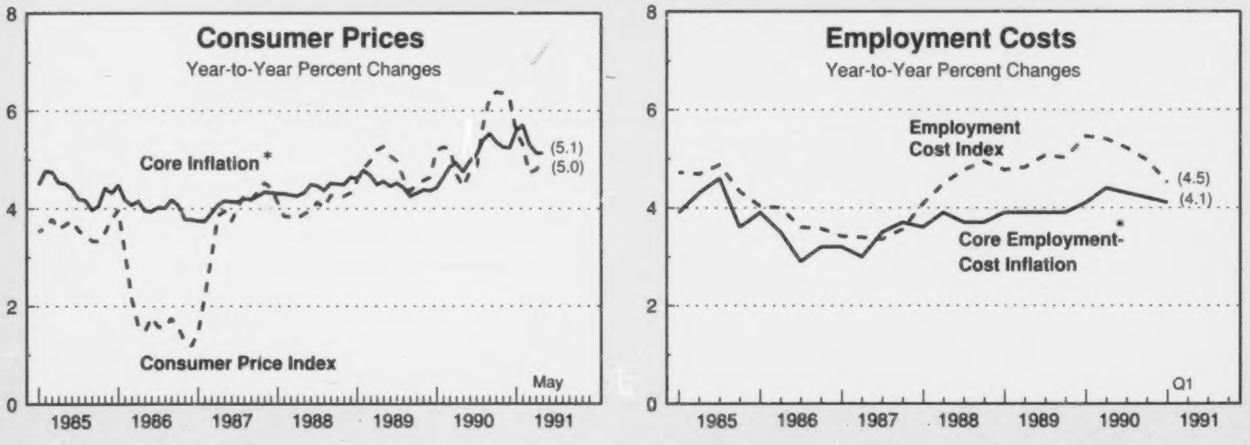
Indexes of Economic Momentum



All three indexes show the beginning of a turn in momentum.

Core inflation rates still seem slow to subside.

Inflation Fundamentals

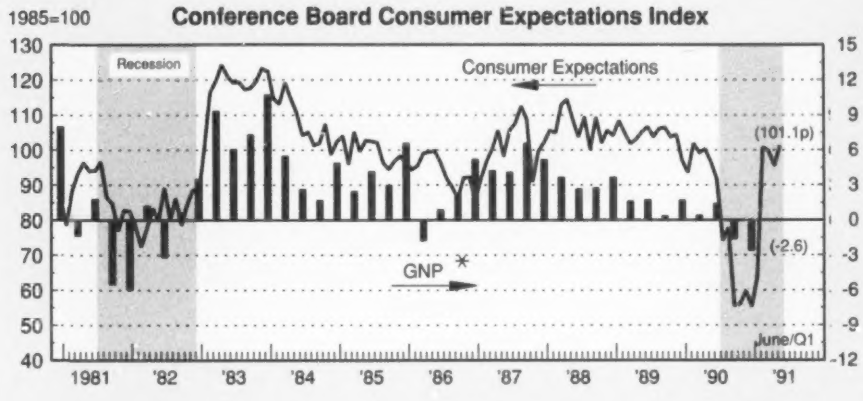


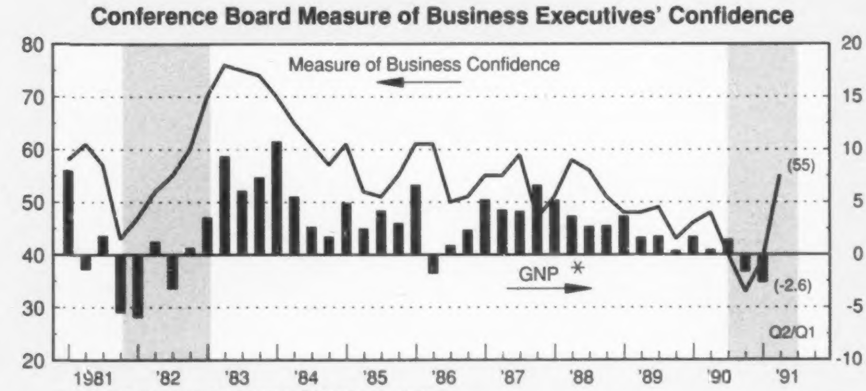
* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

Conference Board Stat File

Confidence

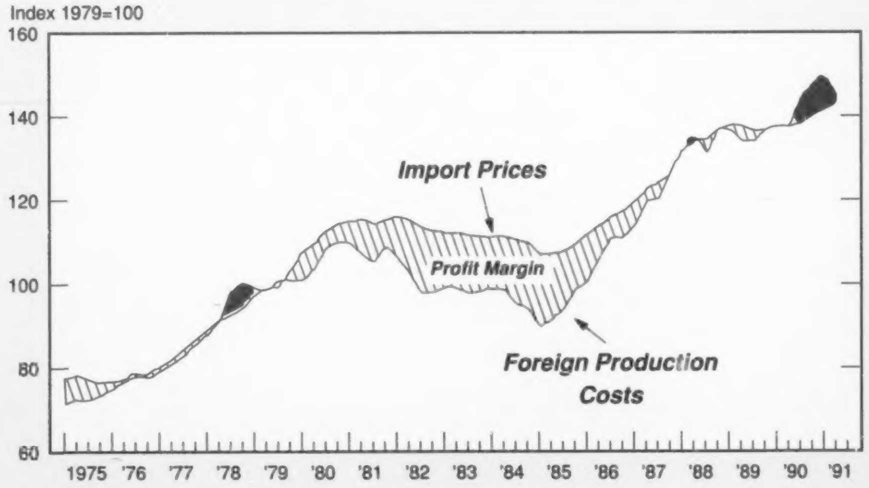




* Quarterly percent changes in GNP at annual rates

No signals here of reluctant attitudes.

Import Prices and Profit Margins



Source: Bureau of Labor Statistics, NIPA, and Morgan Stanley estimates

Imports into the U.S. currently reap losses, not profits.

Inside the Crystal Ball

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Date of Forecast		June	June	June	June	June	June	June	June	June	June	June		

Gross National Product

(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		%	%	%	%	%	%	%	%	%	%	%		
Actual	1990 4Q	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	–1.6	4Q 1990	Actual
	1991 1Q	–2.8	–2.6	–2.6	–2.6	–2.6	–2.6	–2.6	–2.6	–2.6	–2.6	–2.6	1Q 1991	
Forecast	2Q	–0.6	–0.4	–0.6	0.2	1.0	2.4	1.4	–0.4	0.5	0.9	0.6	2Q	Forecast
	3Q	1.9	0.9	2.2	3.0	3.3	2.3	5.4	1.8	3.0	2.5	2.7	3Q	
	4Q	3.6	4.6	3.0	3.2	3.3	1.6	4.1	2.8	3.2	3.5	3.3	4Q	
	1992 1Q	4.7	4.5	3.2	3.1	3.1	2.4	3.3	3.9	3.7	4.2	2.6	1Q 1992	
	2Q	4.4	3.1	3.7	1.5	3.4	1.8	2.0	3.4	3.2	4.4	2.2	2Q	
	3Q	3.6	2.5	3.9	2.7	3.3	2.2	2.0	3.4	2.3	3.9	2.6	3Q	
	4Q	2.1	2.1	3.8	2.2	3.1	2.5	2.1	2.6	1.8	3.1	2.3	4Q	
	1993 1Q	2.0		3.7			2.4	4.0	3.3	2.4	3.0		1Q 1993	
	2Q	1.6		3.8			2.2	3.5	2.9	2.8	2.5		2Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.1	4.4	4.1	3.8	4.3	4.5	3.0	4.0	3.5	2.8	3.9	1991 4Q	Forecast
	1992 4Q	2.9	4.1	3.6	3.5	3.9	4.7	2.6	2.9	3.1	3.3	3.6	1992 4Q	

30-Yr Treasury Bond Rate

Actual	1990 4Q	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	8.6	4Q 1990	Acutal
	1991 1Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	
Forecast	2Q	8.4	8.3	8.3	8.3	8.3	8.1	8.3	8.2	8.3	8.2	8.3	2Q	Forecast
	3Q	8.5	8.4	8.2	8.4	8.4	8.3	8.7	8.0	8.4	8.3	8.3	3Q	
	4Q	8.6	8.5	7.8	8.4	8.2	8.3	8.6	7.9	8.7	8.5	8.2	4Q	
	1992 1Q	8.7	8.7	7.7	8.5	8.3	8.6	8.6	8.0	8.8	8.6	8.1	1Q 1992	
	2Q	8.7	8.6	7.8	8.7	8.3	8.6	8.6	8.2	8.8	8.7	8.1	2Q	
	3Q	8.8	8.6	7.9	8.7	8.4	8.6	8.7	8.2	8.6	8.8	8.0	3Q	
	4Q	8.9	8.5	7.9	8.6	8.5	8.6	8.7	8.2	8.4	8.9	7.9	4Q	
	1993 1Q	8.9		8.0		8.6	9.1	8.8	8.1	8.4	9.0		1Q 1993	
	2Q	8.9		8.0			9.1	8.6	8.0	8.3	9.1		2Q	

Unemployment Rate

(Percent, quarterly)

Actual	1990 1Q	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	1Q 1990	Actual
Forecast	1991 4Q	6.5	6.9	6.7	6.9	6.9	6.9	6.8	6.9	6.9	6.7	6.7	4Q 1991	Forecast
	1992 4Q	5.8	6.5	6.3	6.7	6.5	6.6	6.7	6.3	6.4	6.1	6.5	4Q 1992	
	1993 2Q	5.8		6.1			6.4	6.2	6.0	6.3	6.0		2Q 1993	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

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Industry Outlook Report

July/August 1991

Overview

Edgar R. Fiedler
The Conference Board

The industry specialists we have collected to report on the outlook for the next year or two are agreed that happier days are ahead, at least in the sense that the business cycle is turning toward expansion again. They are not quite agreed, however, on the timing of that event: Some say the turn has already taken place, but others look for it during the second half of the year.

The degree of optimism is also a mixed bag, clearly on the cheerful side of the spectrum, but generally restrained. On average, this group is more hopeful than our panel of last April.

The closest thing to ebullience is found in the report on capital equipment, where Mitch Quain says that overall the sector is "healthier than at any time in the past ten years. Costs are down, companies are lean, … and all parts of the world are moving capacity to the United States."

More representative of the panel's tone is Roz Wells' comment about retailing, "This time, the usual bounceback will be muted by a less than robust recovery in housing and moderate gains in income." Similarly, Maryann Keller suggests the "cyclical recovery in vehicle sales is likely to be shallower than in the past because the purchase price of new cars has risen faster than incomes…Almost 25 weeks of household income are needed to buy the average car today compared to 19 weeks in 1980."

Randy Jayne probably identified the consensual position of the group when he spoke of the *bittersweet* outlook for aerospace. He contrasts "the continuing reductions in defense spending" against the encouraging future for commercial transport, and points to the "consolidation, shakeout, dropouts, and creative partnering" that will create "a smaller set of leaner companies" in the industry.

The report can be summarized by noting that the recession is over, or nearly so, and sooner or later the recovery will lead most industries back to better times.

Motor Vehicles

Maryann N. Keller
Furman Selz

During the second half of 1991 vehicle demand should gradually improve from the extremely depressed sales rates of the first half. Nevertheless, total vehicle demand will only reach 12.7 million units for the year, the worst since the 1982 recession when 10.6 million cars and trucks were purchased. Peak demand occurred in 1986, when total sales reached 16.4 million.

Because of growth in Japanese "transplant" production, General Motors, Ford and Chrysler will assemble only 4.2 million cars in 1991, 1.1 million more than in 1982, but down 3.2 million since 1986 when these three companies produced 7.4 million cars. Although Japanese auto imports have fallen, local assembly increased supply and raised the foreign brand share of the market to 35.5 percent in 1991, compared to 27 percent in 1982. Honda and Toyota each sell more cars than Chrysler, which has been pushed into fifth place.

The battle for market share intensified with aggressive sales by rental companies of "nearly new" four-months-old, low-mileage rental cars, retailed at substantial discounts to the prices of brand new models. Almost two million such cars were bought in 1991 and they reduced new-car sales to private customers. Automakers have modified the programs for 1992 so that fewer of the "nearly new" cars will be sold to the public.

Although domestic companies reduced costs, competition reduced profitability, so that all three will report losses of more than $3 billion for the year. Competition has forced the domestic companies to continue high levels of capital spending in spite of the losses. GM and Ford both have sufficient access to capital but Chrysler has been forced to sell assets to fund product investment. Competitive advantage has shifted to those with sufficient capital at affordable rates.

The cyclical recovery in vehicle sales is likely to be shallower than in the past because new car prices have risen faster than incomes. Today's new car costs $16,500 compared to $7,574 in 1980. Almost 25 weeks of household income are needed to buy the average car today compared to 19 weeks in 1980. A decade ago the industry lengthened maturities of auto loans to 60 months. Since loan maturities will not be extended further, industry price hikes above increases in income will reduce vehicle demand or shift the mix in favor of less expensive models.

Currently consumers are being treated to heavily subsidized leases. These cannot be continued, however, because they are based on inflated residual values.

Next year auto sales could rise to 9.5 million units and trucks to 4.6 million units, an increase in total vehicle demand of 1.4 million units over 1991.

Aerospace

E. Randolph Jayne
McDonnell Douglas
Missile Systems Co.

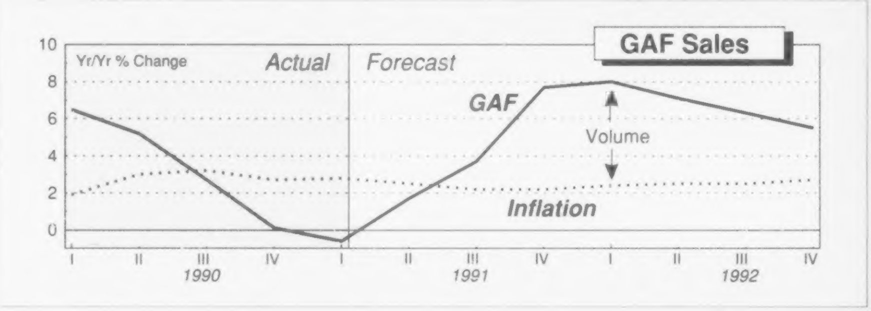
The ten year outlook for aerospace is indeed bittersweet. On the one hand, the continuing reductions in defense spending here and abroad portend downsizing, consolidation, and at some point, fewer total weapons producers. In space, the Space Station and other initiatives hold the possibility of sustaining a portion of the current industry through the decade, but budget constraints threaten here too.

The good news, and the encouraging future, lies in commercial transport. World airline capacity growth, plus normal replacement of older inventory, suggests continued strong demand in this sector well into the twenty-first century. Revenue passenger miles will more than triple by 2010, according to industry forecasters. Existing 1991 airliner backlog stands at over 3500 planes, valued at $200 billion.

Taken together, these military, space, and commercial forecasts suggests two trends for the decade of the '90's. First, companies will strive to shift resources from defense to commercial aerospace, a process far easier for airframe, electronics, and component makers than for producers of land and sea weapons. Second, consolidation, shakeout, dropouts, and creative partnering will characterize all of aerospace, as a smaller set of leaner companies compete for a smaller defense market and a growing commercial aircraft business. For those companies able to straddle and, when necessary, shift back and forth between those markets, the future will be bright. Others, less able to restructure and transition, will join the slow but steady casualty list of world aerospace since World War II.

General Merchandise Retailing

Rosalind Wells
Wells & Associates



After two very tough Christmas seasons, general merchandise retailers finally have something to look forward to. The economic evidence clearly is pointing to a second half turnaround. GAF sales (sales at general merchandise stores, apparel specialty stores and furniture and homefurnishings stores) have already bottomed out in April and May. No doubt, some of the strength in May was due to warmer-than-usual weather that prompted the purchase of summer clothing, outdoor furniture and cooling equipment. Although some of these sales may have been accelerated, consumer demand is responding to the better economy and will continue to improve into next year.

This year's quarterly sales pattern will be the opposite of last year when increases deteriorated as the year progressed. The economic recovery and easy comparisons to holiday 1990 will produce hefty GAF sales gains of close to 8 percent for retailers in the fourth quarter of 1991. Yearly results, however, will average 3 1/2 percent — hardly better than last year. Next year, as the economy continues to expand, GAF sales will be up about 6 1/2 percent. Consumers will remain very price conscious over this period, thereby preventing an upsurge in GAF prices. Sales volume advances will, therefore, improve from 1 percent in 1991 to 4 percent in 1992.

During recovery, periods durables such as major appliances, which have been cut back the most, normally show the strongest rebound. This time, the usual bounceback will be muted by a less than robust recovery in housing and moderate gains in income. Instead, decorative home textiles including bed and bath items will outperform the higher ticket purchases. Apparel and accessories will do well — especially if prices are kept under control — with women's and children's experiencing higher growth than men's. Sales of leisure goods, including home electronics, sporting goods, toys, hobbies and photography have suffered due to cutbacks in discretionary spending during the recession. Sales of this merchandise will get a lift as consumers have more money to spend to fulfill pent-up demands.

Financial Services

Francis H. Schott
Consultant

The financial services industry should benefit substantially from the likely end of the recession in the second half of 1991 as well as from the subsequent expansion in 1992. This outlook is a welcome change from the seriously depressed profit and employment conditions of the past three years.

Naturally, the outlook differs widely among the various segments of the industry. Mutual funds have been successful in attracting new funds and investors in a growing variety of products — specialized equity, bond and money market funds. Therefore, the asset-management segment of the industry has been doing well and should continue to do so.

The investment banking and brokerage community is the sector of finance likely to benefit most from the impending recovery. Stock and bond offerings were rising in the first half of 1991 and should mount further. Trading volume is running 10-20 percent above year-ago figures, and profits should register similar increases over the next 18 months.

Within the insurance industry, the property/casualty segment does best in a low-inflation, early-recovery environment and thus enjoys a good outlook. The life, pension and health companies continue to experience ferocious competition, cost pressures and asset problems. Their recovery will be slow.

The depository institutions have been the most recession-affected sector of finance. Their asset problems, concentrated in commercial real estate, will be bothersome until mid-decade. The savings & loan shakeout may be at the point where the survivors will do better from now on, as residential real estate revives. However, the full extent of the commercial banks' real estate and HLT (highly leveraged transactions) problems is only now becoming apparent. The bank's profit outlook remains dubious except for selected regionals and locals. The entire industry faces consolidation and internationalization moves during the 1990s. By decades' end many foreign-institution names will become household words here. There is also a good chance that top U.S. institutions will be successful in the (consolidated) European market and in the Japanese market.

Telecommunications

John S. Bain
Raymond James
& Associates

After an almost hysterical runup in 1989, stocks of the telecommunications common carriers have underperformed the general market indexes. The cause of this relative lack of performance can be traced to overoptimism regarding the industry and a naive belief among investors that the telecommunications industry was somehow "recession proof." The optimism related to the prospects for cellular mobile radiotelecommunications service, to the supposed benefits of "reregulation," and to the notion that the common carriers had somehow become "growth" companies. In addition, it was widely believed that the fundamental growth in the demand for telecommunications service had reached a permanently high rate in the mid-double digits.

All of these notions have been to some extent discredited. The demand for service has proven to be sensitive to both the economy, and to the price reductions that characterized the industry from 1984 through 1989. At present, it appears that such price reductions are at an end, with the result that most observers now feel that long-term growth in the range of 8 percent to 10 percent is more likely. Even such sure-fire, "can't miss" investment ideas as cellular have suffered a significant decline in market valuations since the late-1989 peak.

However, although the positives may have been exaggerated, there is some truth to all of them. Cellular is a growing and valuable technology. Price cap and other alternative forms of regulation do offer potential benefits to investors. And the telecommunications industry is somewhat recession-resistant, although less than was commonly thought.

The 1992 Outlook. Assuming that we really are near the bottom of the recession, resumption of economic growth should bring a sharp rebound in the growth of demand. In particular, access-line growth should return to the 3.5 to 4.5 percent rate that characterized most companies until 1990. On the long-distance side, we anticipate a rebound to 10 percent or better in 1991, up from 7 percent or so in 1991, with long-term demand growth settling out in the 8 to 10 percent range.

If the market has been surprised by the extent to which the recession has affected the industry on the downside, then it should be equally surprised by the extent of the rebound. We estimate that revenue growth will nearly equal volume growth for the first time since 1984. What this adds up to is a healthy outlook for both volume and revenue growth in the latter half of 1991 and into 1992.

Airlines

Helane Becker
Lehman Brothers

The airline industry is on the road to recovery. After nearly two years in recession, in which earnings have deteriorated dramatically, we expect gains this summer to continue into 1992. Since mid-1989, airline traffic growth stalled, while earnings sequentially declined, until the industry reported $5.2 billion worth of losses in the August 1990-March 1991 period.

Beginning towards the end of March, and then continuing through 1991's second quarter, airline traffic growth began to recover. Much of this recovery is directly attributed to promotional fare activity. The industry reinstituted Kids Fly For Half Price, which prompted many families to book summer vacations. Other discount fares involve travel to and from Europe, and in some cases include doubled or triple mileage for frequent fliers.

As the U.S. economy recovers, the airline industry's recovery will accelerate. This cycle was a particularly difficult one for a number of airlines, especially as there are a record three operating in bankruptcy. Consumers have been actively voting for their favorite airline. Market share in the airlines considered to be financially solvent is increasing, while that of other, weaker airlines is decreasing.

Part of the reason for the decline in market share among those airlines considered poor credits is what we refer to as the transfer of wealth. Wealthy airlines have been buying up the assets of their financially weak counterparts. The financially weak airlines gain cash to continue funding operations while they attempt to restructure. Unfortunately, these airlines tend to engage in payroll pricing, and they keep yields low. This has a negative effect on all other airlines.

Over the next few quarters, we expect the industry to report better operating results. The cost of jet fuel is down dramatically. Traffic is beginning to resume its growth. Pricing is likely to improve later in 1991, as airlines eliminate a lot of the incentive programs for travelers. If traffic growth picks up, pricing improvements are likely to follow.

Airline Operating Results ($ mil)

	1H91E	2H91E	1992E
Revenues	$24,456	$31,000	$63,400
Expenses	26,343	30,000	61,900
Operating Income	(1,887)	1,000	1,400
Net Income	(2,200)	650	975

Clearly, we are looking for a better second half of 1991 than we had in the first half, as well as a 1992 that will be significantly better than 1990 or 1991.

Capital Equipment

Mitchell Quain
Wertheim
Schroeder & Co.

"Cusping" — that's where the domestic capital-goods industry is today. Suppliers of capital equipment experienced a sharp and sudden decline in demand beginning with the invasion of Kuwait last August, culminating in the first quarter of 1991. Ironically, the effect was most severe in those sectors of capital equipment that are normally the most stable. That is, providers of maintenance supplies, spare parts, and companies that sell product through distribution experienced the most severe declines at the manufacturing level. Though the manufacturers — since they've tended to adopt "just-in-time" supply practices — were inventory lean, their distributors and users naturally liquidated inventory. The domestic industry today has ended that liquidation.

The sectors of capital equipment most closely tied to industrial production have already seen some recovery. Heavy-duty truck orders in April and May rebounded above 125,000 units, compared to a trough of 70,000-80,000 in the first quarter of 1991. A similar rebound occurred in the truck trailer industry. Recovery has not yet surfaced for the normally stable fluid power industry — the hydraulics, cylinders and valves used to power industrial equipment — but that seems to be due to the inventory cycle at the distribution level. The correlation with industrial production should naturally result in a recovery in the second half of this year. Similarly, the industrial lift-truck industry, long thought to be cannibalized by automated material handling systems, is likely to experience its normal cyclical rebound later this year. Finally, suppliers to the early-cycle housing and automotive industries, are looked upon favorably, likely to fully participate in this rebound.

Overall, the U.S. capital equipment sector is healthier than at any time in the past ten years. Costs are down, companies are lean, the rate of growth of productivity rivals virtually any part of the world, and companies located in all parts of the world are moving capacity to the United States. A more favorable federal tax structure relative to other countries is a recent positive. Higher exports have been a result, with the merchandise trade deficit nearly disappearing.

P.4105-804

The Conference Board

Volume 2, Number 8 September 1991

Economic Times

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Serving Business and Society for 75 Years

Editor's Note

A fascinating potpourri on cities and finance and international trade makes up this month's offerings. Nathan Glazer has the podium on what lessons we can derive from the socioeconomic history of New York City during the twentieth century. Then we hear from Alan Greenspan, who provides some striking insights on how the downsizing of economic output proves to be very useful in advancing the cause of freedom both politically and economically.

Next, Jay Woodworth tosses a big bucket of cold water on the widely held notion that our financial troubles are the controlling factor in the cyclical outlook. And on the next page, our Colloquium panel discusses the still-delayed GATT negotiations.

Our *Stat File* has a new feature in this issue, a "Chart of the Month" on the cyclical aberration in the construction industry, stolen (the chart, not the aberration) from our friends at Brown Brothers Harriman. You'll find it on page 10.

More good stuff coming next month, including another Industry Outlook Report. See you then.

Ed Fiedler

Maxim of the Month:

Sigmund Freud was a half-baked Viennese quack. Our literature, culture, and the films of Woody Allen would be better today if Freud had never written a word.

Ian Shoales

Unloved and Unmourned

The twentieth anniversary of President Nixon's comprehensive wage and price controls slipped by the other week — an appropriate time to contemplate the lessons of that singular and somewhat bizarre episode in American economic history.

From today's perspective, there is a striking irony in the relative equanimity with which Americans treat the current 4-5 percent inflation, in stark contrast to the anguish created by the same rate of inflation in 1971 — an anguish widespread and deep enough to induce Nixon to impose controls.

The difference is in the prevailing expectations. In 1971, the norm was the experience of the early 1960s, when inflation averaged about 2 percent annually. Thus 4-5 percent was entirely unacceptable. Today, by contrast, the acceptable norm is the average for the past eight years or so, which is the same 4-5 percent we have now. As long as inflation is moderate and fairly steady, we learn to live with it and accept it as normal. We don't *like* it, but we accept it. Thus currently there is no pressure to adopt controls or any other radical anti-inflation policy.

What Did the 1971-74 Controls Do?

The controls didn't stop inflation, but for the first year and a half or two years the program moderated it noticeably. This short-term success against inflation also helped stimulate economic activity. But the greatest success of the controls was political. They were immensely popular at the outset. The American people saw this move as a bold, decisive initiative that would (they concluded erroneously) deal effectively with a festering, intractable disease that just kept getting worse and worse. The controls probably did more to reelect Nixon in 1972 than anything other than the perception of McGovern as an extreme liberal.

The economic and political sunshine didn't last long, however. Starting about mid-1973, the economy overheated, shortages developed, inflation accelerated, and the controls turned perverse in various sectors, creating distortions and fostering black markets. The severity of the economic troubles that developed, including the 1974-75 recession, can be traced mostly to the Arab oil embargo and price hike, but the controls contributed importantly as well.

As always with price and wage controls, short-term economic and political gains are all you get (and controls don't always give you that much). That's the timeless message of controls: Over the long haul, they do more harm than good. Seen in perspective the damage is not catastrophic, but the net result is negative.

The corollary message is that there is no simple solution to inflation. Normally the only answer is austere policies to create economic conditions weak enough to break the inflationary habit. In most cases this can be done neither quickly nor easily: the costs of bringing inflation under control are heavy. No pain, no gain.

Accordingly, our lesson learned, the controls were allowed to expire in 1974, unloved and unmourned. Let's hope time does not erode the lesson. As Herbert Stein observed recently, price controls are "wrong," like lying or burning the flag.

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to *Economic Times*, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

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Colloquium: GATT Gridlock

Background:

The Uruguay round of negotiations being conducted by the General Agreement on Tariffs and Trade (GATT), designed to stimulate economic growth and improve productive efficiency by further reducing existing barriers to international trade, has dragged on inconclusively far beyond its original schedule. Some observers feel it may end without an agreement.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Question:

How important is it that these GATT negotiations be completed successfully reasonably soon?

Charls E. Walker
Charls E. Walker Associates

They're very important! But GATT negotiations should *not* be completed without fundamental progress in reducing agricultural subsidies and in opening markets to financial services and other goods. In particular, if Western European countries cannot muster the political will to support a positive agreement, the United States, Canada, and Mexico should proceed quickly to organize their free trade association, followed by a hemispheric FTA, followed by the distinct possibility of inviting in Pacific Rim nations as a capstone.

Andrew F. Brimmer
Brimmer & Company

The GATT negotiations should be accelerated. Geographic trade blocs (e.g., European Community and North American Common Market) are continuing to spread. While they aim to reduce barriers among members, they tend to restrict access by those beyond their boundaries. Early multilateral agreement among GATT members is needed to arrest this drift toward segmentation of world trade. In particular, agreement is needed to protect patents and other intellectual property and to promote international trade in services.

Murray Weidenbaum
Center for the Study of American Business

Although it borders on the sacrilegious to say so, breaking the deadlock in the GATT negotiations is not terribly important. Action on trade policy has shifted to unifying Western European economies ("Europe 1992") and developing a North American free trade area. Perhaps GATT has outlived its usefulness. In reducing formal tariff barriers, it has encouraged countries to use a far more harmful loophole — import quotas and other quantitative restrictions on international commerce.

Robert G. Dederick
Northern Trust Company

The world probably won't come to an end if the Uruguay round comes a cropper. Unlike Zachary Taylor, Smoot-Hawley won't rise again. But why take a chance? If we don't move closer to free trade, chances are we'll move further away. A failed Uruguay round would give protectionists both here and abroad the excuse they're seeking. And it would poison the air sufficiently to weaken the hands of those free-trade stalwarts who oppose them.

The Lessons of New York City

by Nathan Glazer

New York City is a very different place from the one in which I grew up. Of course when we contrast the 1920s and the 1990s we deal with a very long period and we would expect much to change. I believe we can learn something from such a contrast.

We can think of things that are the same, or similar, and things that are different. Consider first the similarities. By 1930, New York City had almost completed its population growth. It had almost seven million people. Today, New York is again a city of some seven million. New York was an immigrant city then, and has become again an immigrant city. The immigrants spoke foreign languages then — as many do today — and poured into the public schools to be educated. There were a million children in the schools then, there are a million children in the schools now.

Manufacturing, Race, and Poverty

But now to the changes. I will concentrate on three, because these three taken together are generally considered the cause of New York's current difficulties. New York City was then a great manufacturing city and port, a city that produced things, and that moved things. It has lost much of its manufacturing, to places where these processes could be carried out more cheaply. Its port functions and everything associated with them have been greatly reduced.

Second, New York City was then a city of Europeans, and it is now, in its majority, a city of African Americans and Latin Americans, with a rising proportion of Asians. The third change is that New York is by some key measures a poorer city. It is aurgued that it is the misfortune of this population to have arrived while economic opportunity declined. Thus New York, from a city with poor people, but people who saw hope, has become a city of poor people, many of whom don't see hope, who despair and become an underclass.

And in response to these three changes we might add a fourth change that makes a difference from the city of the European immigrant past: there has been an enormous expansion of public social services. The city of the past was one in which the work of the city government was on the whole traditional: policing, picking up the garbage, putting out the fires, constructing and maintaining roads and bridges, regulating building. Today, social and educational services have expanded greatly.

One measure to this expanded scale of social services is that the schools, educating the same number of children, now have three times as many employees as in the 1930s. The size of public human services and health agencies today would dwarf anything that existed in the age of the European immigrant city.

Despite this expansion, it is generally argued that our social and educational and health services are grossly insufficient. The evidence is all around us, in school dropouts, youth unemployment, unmarried motherhood, abandoned or abused children, increased crime, crowded jails and emergency wards, and expanded drug use. It may seem inhuman to examine whether this analysis makes sense. But let us consider this commonly received wisdom. It may throw some light on our current problems.

Poverty, Without Opportunity?

The change in the New York City job base is commonly presented as the major cause of our problems. But if the jobs of today require more in the way of literacy and education than the jobs of some decades back did, it is also true that the opportunities to acquire education and training have expanded greatly. The replacement of jobs in manufacturing with jobs in business services, social and educational services, the health industries and professions, and government does not necessarily mean a decline in jobs capable of supporting a family, and does not demand on the whole more skills than the migrants and immigrants of the postwar years came with or could acquire. New York, despite the fact that it became a poorer city, remained a city of opportunity. The contrast that is often drawn between yesteryear's "slums of hope" and today's "slums of despair" is illusory.

All during the 1970s, while the city hemorrhaged jobs and population, immigrants flowed into it at a fairly steady rate. They were coming for jobs, skilled and unskilled, they opened small businesses, they joined family members, just as in the past and as if New York were not undergoing an economic disaster. They continued to come in the 1980s and will continue to come in the 1990s.

We continue to see people with language difficulties and limited skills daily taking advantage of opportunities — in retail business, in small enterprises, in the use of the educational opportunities of the city. Our problem, I would argue, is not in large that the opportunity structure of the city has changed. Indeed, in some respects it has changed for the better. It is how we are to understand why so many people cannot take advantage of these opportunities.

Pathology Amidst Prosperity

A second striking fact is this: During the 1980s, when the economy revived, when new jobs were being created, when for the most part unemployment was low, and business searched for entry-level and skilled workers, we saw no great decline in the problems that were attributed to lack of jobs and unemployment. New York City has been acquainted with poverty through its entire history — that is not new. The City had, however, not been acquainted with the presence of a large group for whom the words poverty and unemployment did not seem to provide a proper identification. There was a growing complex of female-headed families, high rates of illegitimacy, a growing number of young men neither in the labor force nor in school, high levels of crime. There was a growing drug problem that devastated communities whether the city was prospering or not.

In a word, the poverty we see today, and that is presented as the cause of the social problems that afflict the city, is so different from the poverty of that earlier immigrant city as to not seem the same thing at all. That earlier poverty could be overcome through opportunity to work; it could be assuaged through welfare and social insurance programs designed for hard times and misfortunes. This new poverty seems impervious to opportunity and to the business cycle, neither going up when times are bad nor down when times are good. This is the change that in the large makes the city of today so different from the city of the 1920s.

We have become the kinder city that the reformers of the 1930s fought for. Our welfare is more extensive, more generous than in the 1930s (though we have declined a good deal from the generosity of the late 1960s). We have cleared great areas of the city of old tenements and replaced them with modern housing. We have greatly increased the staffing of our schools, most of it for teachers and teachers' aides. We have created new institutions of higher education, and opened them wide to anyone who gets a high school degree. But all this, it seems, does not do much to create a better city, with less poverty, lower crime, less drug use, fewer social problems.

Senator Moynihan, writing in *The Public Interest* in 1989, reviewed the great spate of social programs designed to overcome the poverty of the 1960s and considered where we succeeded and where we failed. These social reforms, he wrote, were hugely successful "when we simply transferred income and services to a stable, settled group like the elderly. [They] failed where poverty stemmed from social behavior."

That is a startling point, little made or noted in present-day politics or social analysis. We think of poverty as owing to economic change, lack of opportunity. It can also be owing to personal behavior. People bring misfortune on themselves. One can insist that poverty is the root cause, but people in similar situations will respond differently. Some girls will become pregnant and some won't. Some boys will father babies they cannot support and some won't. Some will become drug addicts and in the same circumstances others will not.

Our immediate response to problems is — deal with them. Add more social workers, policemen, therapists and doctors. And indeed, what else can we do? But is there not another task, which is to try to change the self-destructive behavior, rather than deal with its consequences, or rush into finding excuses for it? I have been deeply impressed by Roger Starr's analysis in *The Rise and Fall of New York City*:

> Far from attempting to impose moral order on the poor, society has adopted a neutral attitude in moral matters...Consider the case of a hospital in New York City that dedicates a ward to the treatment of patients with...an infection of the heart....In this ward are placed those patients who contracted their disease by injecting their veins with narcotics, using an infected needle.

Starr describes the difficulty and expense of the treatment. The patients, suffering the symptoms of withdrawal

> are graceless, even insulting, impatient, destructive, dirty, doomed people snatched from addiction unwillingly and usually prepared to return to it upon their release from the hospital. With their renewed addiction will return all the nasty and dangerous ways of getting the money to pay for the narcotics: stealing, mugging, perhaps even murder...The treatment of the patients in this ward is paid for by government or given free by the hospital. The patients are, in effect, treated no differently than they might be if they had incurred an infection while trying to save someone's life rather than in the process of trying...to end their own. It is altogether proper that they should be saved...Yet, somehow, to say that they should be saved is not enough.
>
> What seems missing is the passing of judgment on the matter.

I find this a very powerful comment on our present social difficulties. In the New York of the 1920s and 1930s, judgment was passed in profusion. We had the deserving and the undeserving poor, we had an 18th Amendment that banned alcohol, we had the universal condemnation of illegitimacy, the illegality of abortion, and relief by private groups that took upon themselves the passing of judgment on proper and improper behavior. In the 1960s, all that changed, and we are in many ways the worse for it.

Would the passing of judgment help? The question is, what do we do when poverty is the result of self-destructive behavior? Can we set a standard for behavior towards oneself and one's family and one's neighbors — and if we set it forcefully, and uncompromisingly, would it help?

Excerpted from the *Bulletin of the New York Academy of Medicine* and *The Public Interest*. Nathan Glazer is co-editor of *The Public Interest*.

Small is Beautiful

by Alan Greenspan

One little noticed structural change that has had a profound impact on the world economy and world politics in recent decades has been the marked downsizing of economic output. Economic value creation has shifted increasingly toward conceptual and impalpable values with decidedly less reliance on physical volumes.

A half century ago, for example, our radios were bulky and activated by large vacuum tubes. Today, the same function is served by pocket-sized transistor packs. Similarly, thin fiber optics is replacing vast tonnages of copper. Even the physical quantity of goods consumed in creating economic services has been affected. Financial transactions, historically buttressed with reams of paper, are being progressively reduced to electronic charges, though the sheer volume of activity has kept paper usage higher.

The considerable increase in the economic well-being of most nations in recent decades has come about without much change in the bulk or weight of the gross national product. In fact, if all the weight of materials — the tons of grain, cotton, ore, coal, steel, cement, etc. — we produce were added up, their total volume per capita might not be much greater today than it was, say 50 or 75 years ago. This would mean that increases in the conceptual components of GNP — that is, those reflecting advances in knowledge and ideas — would explain by far the major part of the rise in real GNP in the United States, and presumably the industrial world as a whole.

In the years ahead, telecommunications and advanced computing, which have greatly extended our analytical capabilities of substituting ideas for physical volume, will take on an even greater role. By facilitating the transfer of ideas, they create value by changing the location of intellectual property, much like the American railroads in an earlier time created value by transferring physical goods to geographic locations where they were of greater worth. At the turn of the century, for example, we created economic value by moving ore from the Mesabi Range down to the Pittsburgh district where it was joined with coking coal to produce steel. In today's environment, economic value is increasingly created by moving the conceptual part of GNP — not coal or ore but data, analyses, and insights — from one location to another through increasingly sophisticated electronic means.

The purpose of economic production does not change. It still serves human needs and values. But the form of output is becoming increasingly less palpable.

One clear implication of economic product downsizing is the impact on international trade, which is having a profound effect on the policies of the world's economies. International trade in construction gravel and fiberglass insulation, for example, is limited by weight and bulk. High value computer products, on the other hand, are major and increasing factors in world trade. Obviously, the less the bulk, and the lower the weight, the easier it is to move goods across national boundaries. It is not surprising, therefore, to find that the share of U.S. foreign trade carried by air has doubled since 1970.

But the increased ease with which economic goods and services can spill over national borders creates a major dilemma for the political structure of a country inclined to inhibit such movement. The political leadership must increasingly accelerate the protectionist blocking of goods and services or open up their economy to a more market-oriented, and less domestically regimented, system. In addition, the development of satellite technology, and the ability to transmit television pictures across national boundaries undercuts political censorship of the media. Governments must then either acquiesce in new political freedoms or produce increasingly harsh regimes.

The breakdown of political barriers to the inexorable pressures of cross-border movements of economic goods is especially visible on the European continent. And the evolving newly industrialized countries of the Far East, capitalizing on their ability to exploit the downsizing technologies of the 1980s, have flourished beyond expectations. These models, in turn, have had a profound effect on other developing countries of the world where discarding of centrally planned economies has accelerated, and the old heated so-called north-south political debates of a decade ago have faded.

Countries, however, can eschew international economic cooperation. They can move in a severely protectionist direction. But the extraordinary downsizing of goods will make protectionism increasingly difficult to sustain in the years ahead, in the same sense that repressive national governments will have difficulty blocking satellite-transmitted ideas to their people.

Certainly, a major world economic disruption could induce a hasty resurrecting of the protectionist walls of an earlier era. But technology is irreversible. The downsizing of goods will continue. As a consequence, the ability to suppress worldwide trade will become progressively more difficult in the decades ahead.

Excerpted from a speech to the Japan Society, New York, May 22, 1989. Dr. Greenspan is Chairman of the Board of Governors of the Federal Reserve System.

Don't Exaggerate Financial Problems

by Jay N. Woodworth

The current "consensus" forecast among U.S. economists, which calls for a modest 2.6 percent economic recovery in the first year of expansion, really represents two distinct groups. First, there are the Recessionists or Double-Dippers, who think that the accumulated carnage of problems in the financial sector will short-circuit the economic recovery. This camp points to the enormous volume of funds needed to finance closing the failing savings-and-loan associations, larger Federal budget deficits, hundreds of distressed banks, and the new threat of failing life insurance companies.

We're in the second camp, with those who believe that the recovery will produce real growth of 3-3 1/2 percent during the first year, well short of the 6.5 percent "average" for postwar recoveries but faster than the 2.6 percent consensus forecast.

One reason we're not in the Recessionist camp is that today's financial problems are not all *that* extraordinary. They are, rather, typical of those that invariably spring up in the early months of recovery. The first round of postwar financial shocks began after the mini-recession in 1966-67, with cascading failures of brokerage houses. After subsequent recessions, the U.S. has seen the collapse of hedge funds, the real-estate investment trusts, countless S&Ls, and W.T. Grant. There was the near-collapse of Chrysler Financial (in 1970), New York City (we're thinking of the 1975-76 episode and not trying to make a forecast), and Lockheed.

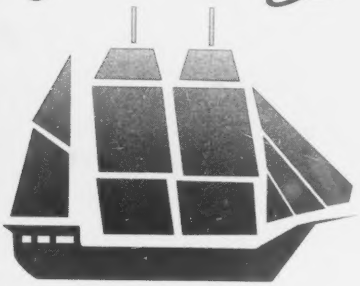
None of these earlier shocks or other financial problems (e.g., the Latin debt mess in 1982) prevented economic recoveries from blasting off the launch pad. The difficulties might have elevated real interest rates and raised the cost of corporate capital, so that the growth rate of the subsequent recoveries *might* have been trimmed slightly. But hard evidence is lacking.

Similarly this time, we do not see that the well-reported financial problems will prevent the recovery from taking place. The troubles will continue to elevate real interest rates and, in our thinking, these do serve to restrain growth rates to the 3-3 1/2 percent zone, rather than 5-6 percent, so the headaches in the financial sector are not trivial.

Another way of expressing this point is to say that we in the financial sector should be careful about extrapolating the problems and the importance of the financial sector to the industrial side of the economy. The unambiguous evidence in the postwar era is that economic recoveries are demand driven — chiefly by the American consumer — and they are not really supply-side constrained (i.e., by limitations on credit or available capital). There is nothing in the current expansion that is different.

Excerpted from "NEXT WEEK," July 26, 1991, a newsletter published by the Economics Group, Global Corporate Finance, Bankers Trust Company, New York. Jay N. Woodworth is Vice President and Senior Domestic Economist.

Sea Story



The Gulf War has revived some of the glory of military experience, and the old veterans have brought their war stories out of mothballs. A grizzled sea dog I know recounts the following tale, which I feel sure (but he won't admit) is strictly apocryphal.

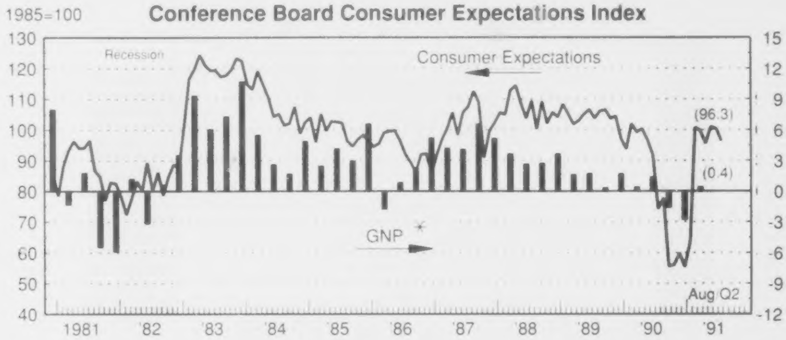
On 23 August 1779, the U.S.S. Constitution set sail from Boston with 475 officers and men, 48,600 gallons of water, 7,400 cannon shot, 11,600 pounds of black powder, and 79,400 gallons of rum. In Jamacia on 6 October she took on 826 pounds of flour and 68,300 gallons of rum. In the Azores on 12 November she provisioned with 550 pounds of beef and 64,300 gallons of Portuguese wine. She set sail for England, where she defeated five British men-of-war and scuttled 12 English merchantmen, salvaging only their rum. Out of ammunition, she nevertheless raided the Firth of Clyde, her landing party capturing 4,000 gallons of whiskey. The Constitution then headed for home, arriving in Boston harbor on 20 February 1780 with no cannon shot, no powder, no food, no alcoholic spirits, but 48,600 gallons of stagnant water!

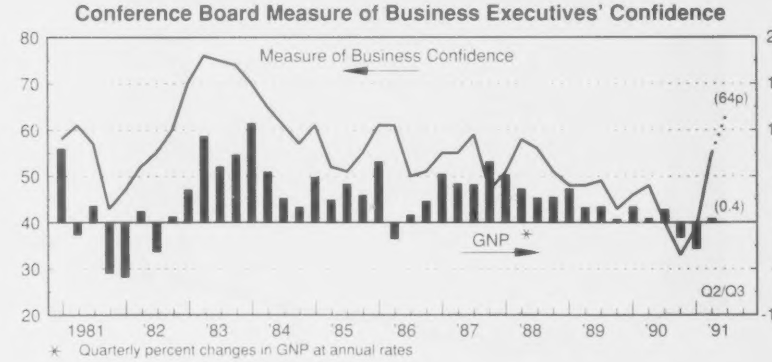
Conference Board Stat File

Recovery Marches On — With Exceptions

Most of the data in this month's *Stat File* show the business cycle recovery proceeding in standard fashion. Surprising strength is found in business executives' confidence and the momentum index for industrial production. On the other hand, the labor market indicators (bottom of this page) continue to lag, as is often the case at cyclical troughs. Also, some sectors of the construction industry are AWOL from the recovery (as shown in our new feature, "Chart of the Month," page 10). *(Note: Data for Conference Board series in this section are available on request from Ken Goldstein at 212-339-0331.)*

Confidence

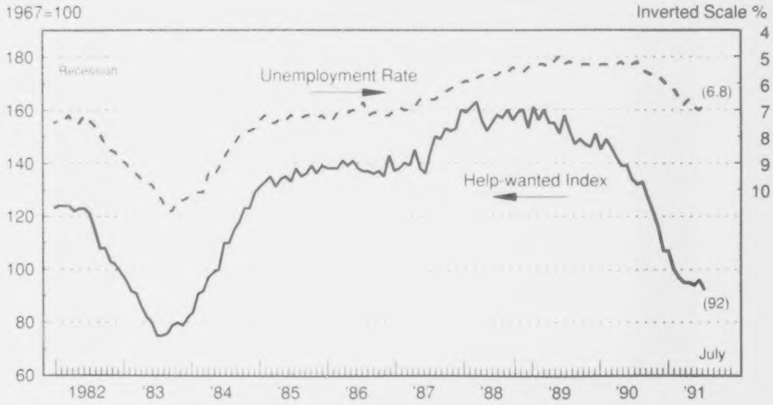

Conference Board Consumer Expectations Index


Conference Board Measure of Business Executives' Confidence

* Quarterly percent changes in GNP at annual rates

Attitudes continue to look favorable.

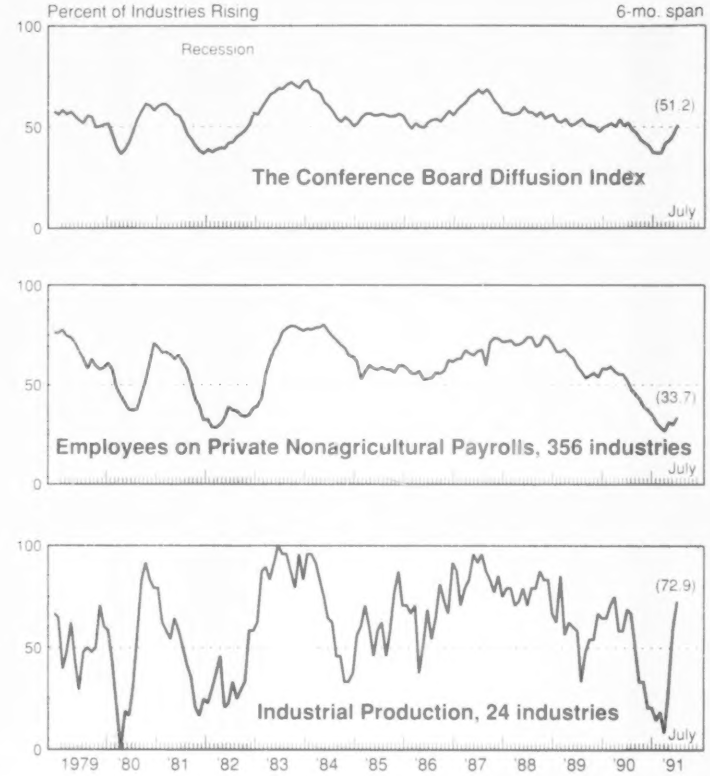
Help-wanted Advertising and Unemployment



Still weak.

Conference Board Stat File

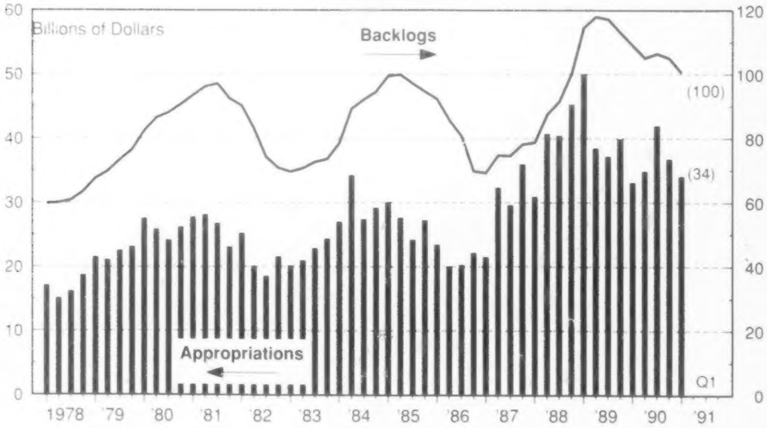
Indexes of Economic Momentum



The turnaround in momentum is now unmistakable.

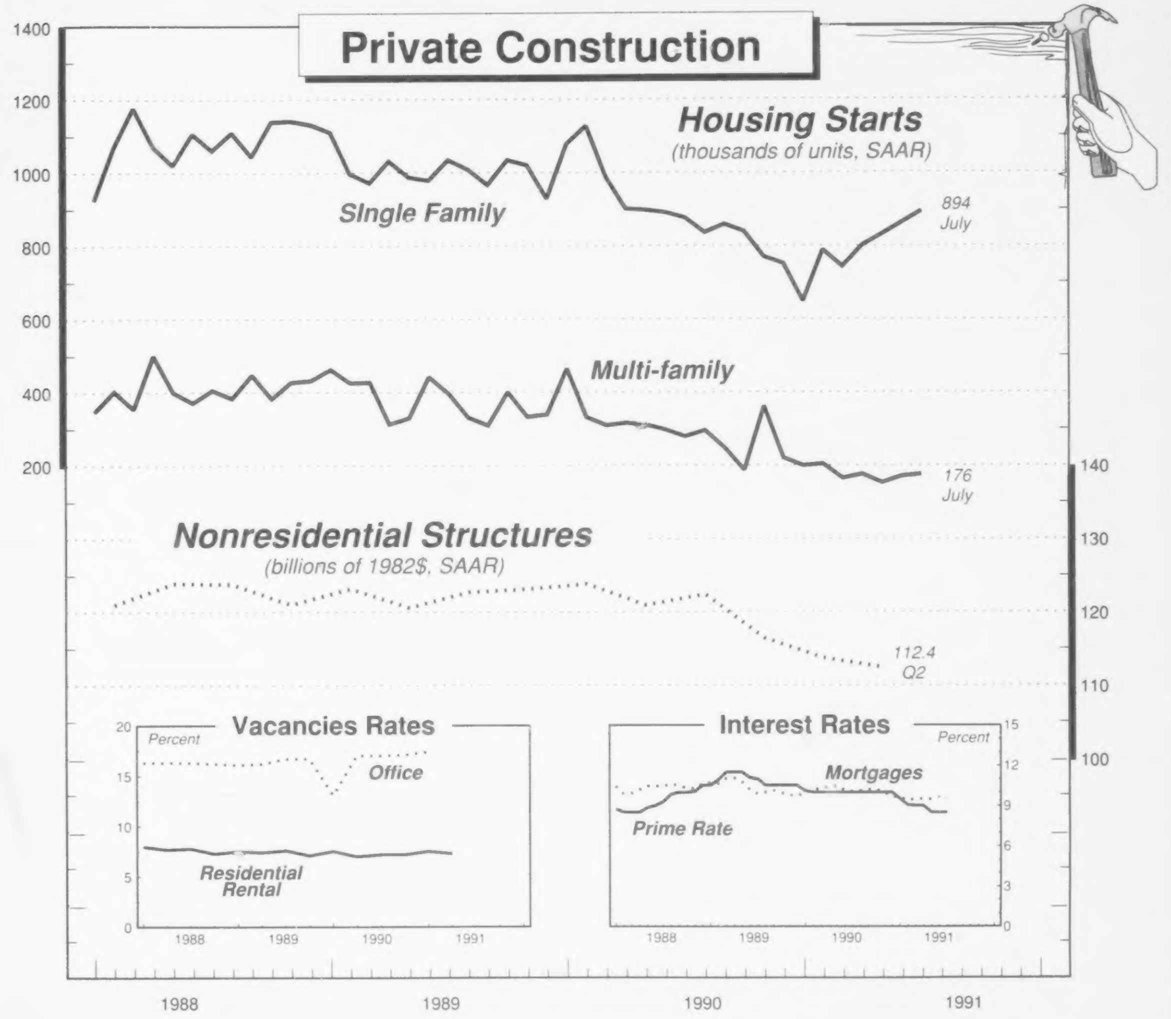
Investment Intentions

Conference Board Capital Appropriations Manufacturing



Recession impact still moderate.

Conference Board Stat File:Chart of the Month



Cyclical Aberration

Historically, construction activity has always moved strongly with the business cycle. This cyclicality applied to both housing and nonresidential construction, and was driven by the availability of credit and swings in interest rates. In the present cyclical recovery, with interest rates down moderately, single family starts have embarked on what thus far appears to be a normal recovery path. But multifamily and nonresidential activity remains soft. This uncharacteristic behavior reflects several interrelated developments: 1) the continuing high level of vacancies both for rental housing and office space, 2) the debacle in the savings and loan industry, and 3) the continuing impact of the 1986 tax reform legislation (a factor that deserves more weight than it usually receives).

Source: Chart adapted from Edward J. Campbell and James J. Barkocy, Brown Brothers Harriman, *Perspectives on the U.S. Economy*, August 1991.

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN – RSQE		
Date of Forecast		Aug.	Aug.	Aug.	Aug.	Aug.	Aug.	Aug.	Aug.	Aug.	Aug.	Aug.		
Gross National Product	(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)													
		%	%	%	%	%	%	%	%	%	%	%		
Actual	1991 1Q	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	1Q 1991	Actual
	2Q	0.4	0.4	0.4	0.1	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q	
Forecast	3Q	2.0	3.0	2.2	2.4	3.6	2.9	4.1	2.9	3.3	1.5	2.9	3Q	Forecast
	4Q	3.5	4.1	2.5	2.8	3.5	2.4	4.5	2.0	2.9	3.9	3.6	4Q	
	1992 1Q	4.6	4.0	3.2	2.7	3.1	2.5	4.0	2.2	3.0	4.4	3.0	1Q 1992	
	2Q	4.2	2.5	3.3	2.3	3.4	2.1	2.9	3.1	2.8	3.9	2.6	2Q	
	3Q	3.3	2.3	3.4	2.8	3.3	2.2	1.6	3.2	1.8	3.3	2.4	3Q	
	4Q	1.9	2.0	3.3	2.5	3.1	2.1	2.7	2.8	1.9	2.7	1.9	4Q	
	1993 1Q	1.8		2.9			2.5	3.9	3.2	3.1	2.4	1.8	1Q 1993	
	2Q	1.6		2.9			1.9	2.7	2.9	3.4	2.6	2.0	2Q	
	3Q	2.9		2.7			1.0	1.9	3.1	3.4	2.7	2.1	3Q	
Inflation (GNP Deflator)	(Percent change from same quarter one year earlier)													
Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.3	4.1	4.1	4.1	4.3	3.6	3.4	4.1	3.5	3.3	3.8	1991 4Q	Forecast
	1992 4Q	3.0	4.0	3.6	3.8	3.9	4.4	2.6	2.9	2.8	3.3	3.5	1992 4Q	
30-Yr Treasury Bond Rate	(Percent, quarterly)													
Actual	1991 1Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	Acutal
	2Q	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	2Q	
Forecast	3Q	8.4	8.4	8.3	8.3	8.3	8.3	8.3	8.4	8.4	8.4	8.4	3Q	Forecast
	4Q	8.5	8.5	8.0	8.3	8.2	8.4	8.3	8.2	8.5	8.4	8.3	4Q	
	1992 1Q	8.6	8.6	8.0	8.4	8.2	8.3	8.4	8.1	8.7	8.5	8.4	1Q 1992	
	2Q	8.7	8.5	8.0	8.6	8.3	8.3	8.5	8.0	8.7	8.6	8.4	2Q	
	3Q	8.7	8.4	8.0	8.7	8.4	8.3	8.5	7.9	8.6	8.7	8.3	3Q	
	4Q	8.8	8.3	8.0	8.8	8.5	8.3	8.6	7.8	8.4	8.8	8.2	4Q	
	1993 1Q	8.9		8.0		8.6	8.7	8.6	7.7	8.3	8.9	8.1	1Q 1993	
	2Q	8.9		8.0		8.7	8.7	8.4	7.6	8.2	9.0	8.1	2Q 1993	
	3Q	8.9		8.1			8.7	8.3	7.5	8.3	9.0	8.2	3Q	
Unemployment Rate	(Percent, quarterly)													
Actual	1991 1Q	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	1Q 1991	Actual
Forecast	1991 4Q	6.7	6.9	6.7	7.0	6.8	7.0	6.7	6.9	6.7	6.7	6.8	4Q 1991	Forecast
	1992 4Q	5.9	6.5	6.3	6.7	6.4	6.8	6.5	6.3	6.3	6.3	6.5	4Q 1992	
	1993 2Q	5.9		6.1			6.7	6.0	6.0	6.2	6.3	6.5	2Q 1993	

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Statistical Reference Index
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R4105-80 A

The Conference Board

Volume 2, Number 9 October 1991

Economic Times

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Serving Business and Society for 75 Years

Editor's Note

Once again, our publication offers an enormously diverse assortment of articles. All of them relate in one way or another to the economy, although at first glance the connection may seem a bit strained.

Professor Olson from the University of Maryland tells us how both morals and incentives are needed in a well-functioning society. Ben Stein makes his second contribution to the publication (the first: "Power to the People" just a year ago), this time reporting on the lessons of management and economics he has learned from one of his dogs. (Yes, you'll even find the connection to economics in this one!)

Then we have two items arising from behind what we used to call the "Iron Curtain." Joshua Muravchik of the American Enterprise Institute provides some insights on how the essential concepts of democracy prevailed against great odds in the totalitarian socialist countries. And on the next page, our faithful Colloquium panel discusses the pros and cons of assisting the U.S.S.R.

The one "conventional" topic this month is the quarterly *Industry Outlook Report* in the (shaded) center section. Although the topic is conventional, the analysis is anything but.

Have a good month!

Ed Fiedler

Maxim of the Month

Education: the inculcation of the incomprehensible into the indifferent by the incompetent.

John Maynard Keynes

Congrats to the Fed

Q: How is the Fed doing?

A: *Pretty well, I'd say.*

Q: Then you approve of their recent decision to lower short-term interest rates?

A: *I was thinking, rather, about the 7 percent unemployment rate.*

Q: You **like** 7 percent unemployment?

A: *Sure, in these circumstances.*

Q: But that's the highest rate in 5 years. The Fed's supposed to minimize unemployment, not raise it.

A: *The Fed has a gaggle of goals, not always compatible, notably the familiar inflation-vs.-unemployment trade-off. What makes 7 percent unemployment a happy number is the fact that it's not 10 percent.*

Q: Why should it be 10 percent?

A: *No reason it should be, but unemployment exceeded 10 percent in the previous cycle and touched 9 percent in the mid-'70s. So, for the worst point of the cycle, 7 percent is a good number.*

Q: I'll grant you 7 percent is better than 10 percent, but I hope you'll agree that the 5 percent unemployment we had in 1989 and early 1990 was better.

A: *Of course, but you're comparing different stages of the cycle. In fact, your argument seems to deny that the business cycle and the unemployment-inflation trade-off even exist.*

Q: No, I just think the Fed should shoot for 5 percent unemployment rather than be satisfied with 7 percent.

A: *You're asking for the moon, my friend, because 5 percent is not sustainable. That was proven again in 1989, when unemployment worked its way down to 5 percent and inflation began to accelerate gradually.*

Q: That wasn't much of an inflationary outbreak.

A: *Correct, but it was enough to show the economy had been pushed too far. We demonstrated again that 6 percent unemployment is about the sustainable minimum. When the cyclical expansion pushed the unemployment rate below 6 percent, the appearance of new inflationary pressures told the Fed that it was time to apply the economic brakes and, to their credit, they did so.*

Q: I don't see why there was any hurry.

A: *The hurry was to avoid letting the gradual acceleration grow into a major surge of inflation. The worse the price disease gets, the more painful its cure. The real secret of limiting the peak in unemployment to 7 percent here in 1991 was to begin applying the monetary brakes promptly as the unemployment rate approached 5 percent. That was the Fed's triumph, the promptness of their shift to a tighter policy in 1988. A business cycle that swings no wider than from 5 percent to 7 percent unemployment is the best we can reasonably expect. And even that takes good luck, in view of the crude nature of monetary policy, the limitations of forecasting, and the tendency for outside shocks to rock the economic boat.*

Q: So you're saying we shouldn't try to do better than 6 percent unemployment?

A: *Not with monetary policy. Separately, we should try to reform the way our labor markets work, the skill mix of the labor force, and anything else we can do to improve the unemployment-inflation trade-off. But presently 6 percent unemployment looks like the most ambitious target we can maintain.*

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Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to *Economic Times*, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

This publication is printed on recycled paper.

Colloquium: Help the U.S.S.R.?

Background:

In Moscow, the agenda for discussions with the West is dominated by economics. Aid to the Soviet Union, or to its various republics, is a controversial issue, one that's sure to be with us for some time How much aid, if any? What type? Should assistance be conditioned on economic and political reform?

Question:

In your view, should the United States and other industrial nations provide aid to the U.S.S.R. any time soon?

Robert G. Dederick
Northern Trust Company

If humanitarian aid is needed, it should be offered — no strings attached. Economic aid, by contrast, should be given only if IMF-type conditions are satisfied. What's good for others is good even for the U.S.S.R. And the best way to see that this requirement is met is to grant the U.S.S.R. full IMF membership. Forget that associate status cop-out. In any event, the amount of aid should be limited. For the most part, the Soviets should rely on their own efforts for body-building purposes. How else are they going to develop any muscles?

Andrew F. Brimmer
Brimmer & Company

Despite the erosion of central authority — and the assertion of independence by a number of Republics — economic aid should be provided to the U.S.S.R. There should be a mixture of U.S. assistance: grants of humanitarian aid, low cost food shipments, Export-Import Bank loan guarantees, support for full membership in the IMF and World Bank, relaxation of most restraints on exports of industrial technology, extension of most-favored-nation trade status, and full insurance of direct investment by U.S. firms.

Murray Weidenbaum
Center for the Study of American Business

Should the U.S. provide financial support to the Soviet Union while they continue to build nuclear submarines and other weapon systems? That's ludicrous. To achieve political and economic freedom, the Soviets will have to earn it on their own. We can't bribe them to do it. They grow enough food; they have to learn how to distribute it before it spoils. At most, we should send technical experts to teach them the rudiments of capitalism.

Charls E. Walker
Charls E. Walker Associates

Humanitarian and technical aid? Yes, as soon as logistics allow. Economic aid? Only after an *irreversible* reform program is on track — one that significantly demilitarizes the Soviet Union and establishes a market economy through extensive privatization, a workable price system, and a convertible ruble. This will ultimately attract the private investment that is the key to growth. Official aid, except for humanitarian purposes, should only be complementary to and supportive of private investment.

Members:

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Morals, Incentives, and Effective Democracy

by Mancur Olson

To work well, a society requires not only widespread adherence to appropriate moral codes, but also an appropriate structure of incentives. A good structure of incentives gives the individuals in a society a reason, given individual self-interest, to behave in ways that improve the quality of life. In other words, I think of morals and incentives not as opposites or enemies but rather as indispensable partners, both of which are needed if we are to have a well-functioning society. We also need the right division of labor between the partners: we must note the circumstances in which reliance on morals, on the one hand, or on incentives, on the other, will be most suitable.

The problem begins with the fact that *morality is a scarce resource*. Even after millenniums of preaching, morality is still in short supply. I am not suggesting that moral behavior is rare or characteristic of only a few saintly types. Some amount of moral behavior seems to me to be general in every society.

Suppose you are lost. If you ask for directions, in the overwhelming preponderance of cases, you get them, and you get them for free. Now that's a banal observation, but it nonetheless tells you that the willingness to help others (some degree of altruism) is virtually universal. Similarly, when there is an accident — when someone is bleeding profusely or there is a heart attack — people nearby will almost always help. So I treat moral impulses as general characteristics of the population, not as something that is exceptional.

Yet when it comes to getting society's hard work done on a day-in-day-out basis, it generally appears that morals alone are not enough. Take nations during wars, especially wars where there is a consensus in the population that the nation is right and that it ought to win the war. Even in these circumstances, altruistic impulses are not sufficient to finance the war effort. Every country in these circumstances needs taxes to finance its war effort. Thus there can be no doubt that societies need to use incentives.

One well-known way in which incentives are used to get the world's work done is, of course, through competitive markets, a concept that goes back all the way to Adam Smith. Almost everyone realizes that in certain circumstances markets can function effectively for a society. We all know that there are a variety of market economies, like our own, with reasonable economic performance, and now everyone knows of the economic failures of Soviet-type societies. Thus the idea that the market can harness the self-interest of people to generate desirable social outcomes is one of which most educated people are already aware.

I would like to focus here on the role of incentives, not in private markets but in government and politics. I believe we can get some ideas on how to make our own society and government work better, if we look at the emergence of law and order and government.

Let's ask: How does a peaceful order emerge, how does a government emerge, where there is initial anarchy? My thinking about these questions developed when, by chance, I was reading the biography of a Chinese warlord named Feng. There was a struggle between this warlord's army and a similar-sized army of a roving bandit. The warlord's army won and Feng became famous and popular.

When I read that I thought, "how arbitrary!" What legitimacy does a warlord have? A warlord is nothing but a *stationary* bandit, and thus morally no better than a *roving* bandit. By what moral principle do we prefer a warlord who does his banditry on a fixed location with taxes rather than by roving around?

But suppose we ask how ordinary people would fare when there are just roving bandits, as compared with the situation when there are stationary warlords who defeat the roving bandits and engage in tax-theft instead. The roving bandit takes what he finds and moves on. But the stationary warlord has an incentive to get as much tax revenues as he possibly can. But how can he get the most tax revenue?

He will get the maximum in tax theft only if the domain that he has conquered is productive. The more income that is generated in his domain, the more he can collect in taxes. A good stationary bandit will make sure that there are incentives to produce; he will, in other words, provide a peaceful order (including order with respect to tradeables, which we call "property rights"). With law and order there will be a great increase in production. People will believe, if they expect law and order to continue, that if they produce something they will be able to keep that part of it which does not go into tax revenue. They will, moreover, have incentives to invest, because law and order will mean that they will be able to keep the goods and machines that they have invested in. The stationary bandit or warlord has an incentive not to allow *anyone else* to steal because that will mean less for him, so apart from his taxes there is no other theft allowed.

In short, a bandit will maximize his receipts from thievery if he settles down, appoints himself King, provides government, and takes all his theft in the form of predictable taxes. By contrast, if his armed force instead is used for roving banditry then there will be very little production. People will only produce things that they can hide or consume promptly. There will be a very low level of output indeed, and this will even generate problems for the roving bandits. In anarchy there is not much for roving bandits to steal.

Thus I am suggesting that the beginning of ancient or classical civilization was probably, in many cases, the result of the incentive that conquerors had to set themselves up in the business of government, because what they could get in theft through tax collection was greater than what they could get by migratory pillage. Law and order, then, was something there was sometimes an *incentive* for a conqueror to provide. *The first blessing of the invisible hand was government!* The invisible hand led the conqueror to provide domestic order and other public goods because this made his take larger.

Given my own democratic sensibilities the foregoing argument is troubling. I had to ask myself, "Is it possible that, contrary to what I have always believed, dictatorship is better than democracy, because the dictator will have an incentive to make the society work?"

But one of the things that we observe is that kings and warlords use a large part of their revenue for wars for their personal aggrandizement. Kings maximize their tax collections for the purpose of war as well as for palaces. Even though the king is trying to make the society work, he is trying to make it work so that he can milk the maximum amount out of it. Needless to say, that is not the sort of thing that is best for the subjects. It's better than being a victim of roving bandits, but it is hardly the best sort of situation.

Application to Democracy

Now let us look at the incentives facing a President in a system like ours, or a well disciplined political party in a two party system. If a President wants to get re-elected, then what kinds of policies will he have an incentive to adopt? Will his incentive be like the dictator's incentive to maximize tax collections? Surely not. The best way to get re-elected is to persuade at least a majority of the electorate that their welfare will be higher if they re-elect the existing President or political party.

The welfare of the electorate depends on the *net* benefit of the government's actions for the citizenry. If a President or party succeeds in making the country work well, and succeeds in making it work in the interest of the electorate (or at least the majority of the electorate), then he will have a better chance of getting re-elected by this electorate. Thus the President will, of course, collect taxes, but he has an incentive to impose a level of taxes and public expenditure that serve the interest of at least a majority of the citizenry.

Now one of the things that happens in our democracy is that organized groups find it in their interest to lobby or to collude and cartelize in ways which are good for them but bad for the country. So I'm not saying the simple model that I just described does justice to the current American scene, or for that matter to any other country.

But the simple model does, nonetheless, tell us something. And that is that when we introduce democratic procedures there are officials or parties that can be held responsible for how well the society is working — for *outcomes*. When democratic institutions are structured so that it is clear who is in charge, then those who are in charge can be held responsible and the outcomes for the country can be attributed, in part, to the government or misgovernment of the official or party in charge. When we have that situation, we have a party or official with an incentive to behave in such a way that the welfare of the citizenry — or at least a majority of the citizenry — is taken into account.

Accordingly, even in the realm of government (not only in the marketplace) it pays to think about how to improve the structure of incentives. Though the foregoing account of two-party democracy is oversimplified, it is sufficient to suggest that our country would work somewhat better if there were more party discipline in the Congress. Then the parties would have more of an incentive to make a country work than do individual congressmen, or than the special interests from whom the congressmen get their campaign contributions. We can see, in other words, the benefit of strengthening our political parties. That is desirable because it gives politicians a reason, in their own self-interest, to make the society work better.

I wouldn't want to push the argument that I have made too far. I don't believe it is within the wit of man to work out a society where *everyone always* has a compelling interest to act in a way that is ideal from the point of view of the society. Go back to my trivial example about getting directions for free. It tells us that no matter how much we worked at it, we couldn't set up a market which would work so well that people would *efficiently* get directions for pay!

There are many circumstances, in government and outside of government, where even with the best knowledge in the world we can't put forth a perfect structure of incentives. So there is still plenty of work left over for morality, even after we improve the structure of incentives. Indeed there is so much work left over for morality that we should structure incentives so that we do not need to call on morality any more than we have to.

Excerpted from "The Role of Morals and Incentives in Society" in Joseph E. Earley, Editor, *Individuality and Cooperative Action*, 1991, Georgetown University Press, Washington, D.C. Mancur Olson is Distinguished Professor of Economics at the University of Maryland at College Park. He also chairs the Center on Institutional Reform and the Informal Sector funded by the U.S. Agency for International Development.

Trixie's Principles of Management and Economics

by Benjamin J. Stein

I have seen them come and go. The top dogs of finance and manufacturing and construction, and written about many of them. Some of them, like Sam Walton, came from virtually nothing and built great empires based in part on understanding management. Others, like Charles Keating, Jr., built empires of finance and real estate built upon the sand of fraud. They vanished like Ozymandias because their understanding of management was flawed and fraudulent.

But in terms of managing effectively, coming from nowhere to complete success, and accomplishing prodigies with virtually no financial or educational capital, no manager I have ever seen is in a class with my German short-haired pointer, Trixie. From absolutely nothing, from being an abandoned dog at a kennel for abandoned dogs, with no money, no family connections, no Harvard education or Yale degree, Trixie has gone on to accomplish complete dog success.

She has a loving home, a master who virtually never leaves her side, cradle to grave (which I hope never comes) medical, housing, and nutritional care, and the undying love of everyone who meets her. In dog terms, her security is vastly greater than what any human could expect to achieve even if he were a billionaire. A billionaire, after all, could lose it in a real estate crash, could be indicted for securities law violations, or could get nailed in a divorce. Trixie is secure, and is provided for by other members of my family should I be terminated with extreme prejudice before her. She does not even know the words "grand jury."

How did Trixie do it? What were her management secrets and techniques? As far as I can tell, she had only a few, but she knew them well and lived by them:

1. She knew her goals. She wanted to be loved, fed, walked, kept dry and warm. She did not waste time on fame, fast cars, or women (not to mention wine and song). In this way, she conserved her energy.

2. She rapidly learned who fed her. Within hours of her arrival, she observed that yours truly dispensed the food.

3. She was kind to the hand that fed her. Trixie could not pay for her food, of course, but she could observe that I liked having her be devoted to me and follow me around. She had no cash, but she did have an unlimited capital of devotion. She paid me with that vastly beyond the money value of the dog food I gave her. (As an economist might say, she capitalized on her comparative advantage. She had an abundance of low-cost devotion, while I had an abundance of low-cost food. We traded for our mutual advantage. This is something basic, which few managers indeed know.)

4. She kept out rivals and thereby enjoyed a price-fixed market in my affection and was able to realize monopoly rent or rewards far beyond their market rate or cost of production. By virtue of biting our three other dogs if they came too near to me or seemed to be staking a claim to my affection, and even threatening humans who came close to me, Trixie ensured that she did not have her price lowered to what the average dog would take to be a devoted companion. She kept out rivals with her teeth and her claws, and was able thereby to realize far more attention, food, and exercise than if the other three dogs had been permitted to get close to me.

5. She understood that silence was preferable to argument with the hand that fed her. When she was faced with an unattractive situation, such as being left at home when she did not want to, she did not whine or complain. She simply looked sad, and then went to sleep. That is, she made me feel guilty and eager to appease her instead of threatening me and making me angry. In this way, she further raised her price and value to me, and raised her own income.

The analogy for a human manager would be that if his boss told him to do something he did not want to do, he should look sad, but go about it without argument. This, some might say, is not dignified, and that's true. But on the other hand, collecting added rewards from your boss is dignified — and how much good has arguing with your boss ever done you, anyway?

6. She understood instinctively that looking the part was crucial to success. Trixie is a thoroughbred brown and white German short-haired pointer. She is almost unbelievably good looking. When I walk her, passers-by in cars whistle at her (certainly not at me). Moreover, she looks like a dog. She looks like a Ralph Lauren dog, a prototypical dog, from an English hunting lodge, held by a Mountbatten on a leash.

Obviously, she had nothing to do with that, but she has used it to great advantage. She knows — or at least benefits from — the principle that people like what's pretty more than what's not. They also like what looks like what it's supposed to look like. Trixie knows — or at least benefits from — the principle that appearance means a lot.

That's it. That's how Trixie went from nothing to dog management triumph. She's sleeping under the covers in my bed right now while I'm working, by the way, but you probably already knew that. That's success, after all. That's dog management brilliance.

Benjamin J. Stein is author of *Hollywood Days, Hollywood Nights: Diary of a Mad Screenwriter.*

Industry Outlook Report

October 1991

Overview: Recovery and Competition

Edgar R. Fiedler
The Conference Board

The mood of the industry specialists in this Report encompasses a broad range of expectations from pessimistic to careful cheerfulness. The closest to a sour note is steel, where total deliveries are forecast to hold steady from this year to next, and profits may decline.

The strongest auguries are reported for paper and electronics, where sales and earnings are expected to bounce back sharply in 1992. Business services will see continued increases in demand. In the chemical industry, prospects are more subdued, with modest growth expected but prices remaining depressed.

In the farm community, the outlook is mixed, with grain prices most dependent upon how much food aid and export credits are made available to the U.S.S.R. For the American consumer the most encouraging forecast is that food prices, which advanced 5.8 percent in both 1989 and 1990, will only rise 2-4 percent this year with the slower pace of advance continuing into 1992.

The intensity of competition, especially global competition, is a recurring theme in this Report. Its impact was cited by the majority of our experts — most notably, perhaps, for business services — and was implicit in the others' analyses.

Our oil analyst, Kathy Cooper, concludes her outlook by wondering whether 1992 will produce another "August surprise," like the Gulf war of 1990 and the attempted coup in the Soviet Union this year. Shocks of that sort are, of course, possible at any time. Absent such events, however, our panel is moderately optimistic about the outlook for 1992. They anticipate, on balance, a steady expansion of economic activity in an environment of strong competition.

Electronics: Stronger Growth in 1992

Vladi Catto
Texas Instruments

The U.S. electronics market has been sluggish for the past 18 months, with weakness in computers, automotive and defense electronics offsetting moderate growth in communication, industrial and consumer electronics. Electronics shipments did rebound weakly in July, up 1 percent over June levels, and have now increased in three of the past four months. But this recent improvement will not be sufficient to raise total shipments for 1991 significantly above the 1990 level.

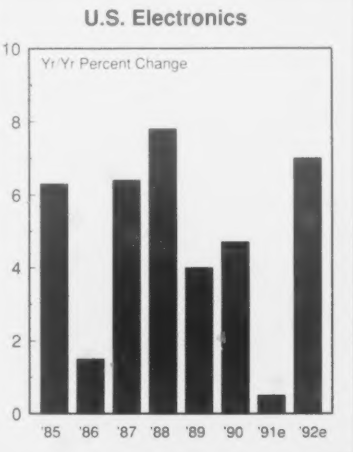
The semiconductor industry, feeding components into electronic end-equipment, continues its moderate recovery from a weak 1990 performance. Demand is benefiting from the rapidly increasing semiconductor content of electronics products. Through this year's second quarter, semiconductor shipments were 6 percent above year-ago levels.

U.S. Electronics
(percent change)

	Shipments	Profits
1990	4.7	-4.6
1991	0.5	-4.0
1992	7.0	+30.0

The U.S. electronics industry is likely to experience stronger growth in 1992 for a variety of economic and technological reasons: The business cycle recovery, now under way, will be moderate but durable. Overseas, the Asia/Pacific region continues to defy gravity with several countries expected to see GNP growth in the 7-9 percent range, Japan still advancing at a healthy if slower pace, and Europe likely to survive 1991 without a broad recession. Electronic equipment inventories remain at historically low levels. The current pricing environment in the electronics industry is more stable than in 1990. Software development is beginning to catch up with the hardware, which will exercise a beneficial pull-through effect on computer sales.

Despite current uncertainties, long-term prospects for the electronics industry are still very positive. We are a long way from reaching the limits of technology. With advances in semiconductors leading the way, electronics will advance from the fifth largest industry in the world today to number one in the next century.



Petroleum: Adequate World Capacity

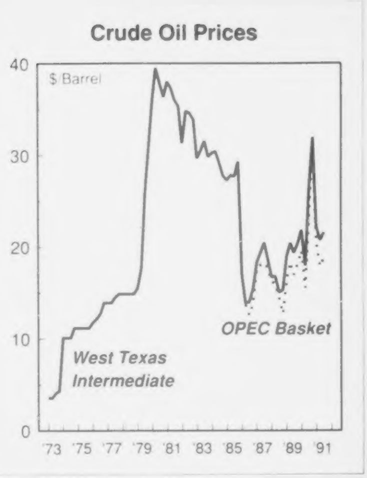
Kathleen B. Cooper
Exxon

This year's "August surprise" barely ruffled world petroleum markets, but the failed coup in the Soviet Union has not erased concerns about Soviet oil production. Because of outdated technology and management problems, output in the world's largest oil-producing nation has dropped by roughly two million barrels per day since 1988 (equivalent to the loss of another Kuwait). Soviet demand has also fallen, resulting in an export decline of around one million barrels per day. New political arrangements and economic reform must still be sorted out by the republics and the central government if the production decline is to be reversed. Furthermore, civil unrest and inter-regional hostilities that disrupt oil exports cannot be ruled out.

The aftermath of the Gulf war — 1990's August surprise — continues to create uncertainty. Iraq is still considering whether to accept the U.N.'s conditions for emergency oil sales (that could lead to roughly 500,000 barrels per day for six months). Fire-fighting in Kuwaiti oil fields is proceeding apace, but exports of more than 400,000 to 500,000 barrels per day by year-end are questionable.

Since the liberation of Kuwait, the OPEC Basket price has remained significantly below OPEC's $21 target. In the absence of Iraqi exports, world demand during the coming winter would bring world oil markets into balance with little spare capacity and could firm prices toward their target. Inventories and surge production capability, however, appear adequate to provide a buffer for a cold winter.

In 1992, the U.S. and Europe's economies should pick up steam, with world oil demand rising accordingly. Uncertainty remains about Soviet production and exports. The real issue, though, will be OPEC's response to growing Kuwaiti and possibly Iraqi exports when demand declines seasonally next spring and summer. On balance, world capacity should be more than adequate in 1992 ... unless, of course, there is another August surprise!



Crude Oil Prices

Steel: Another Year of Profit Declines?

Peter F. Marcus
PaineWebber, Inc.

Shipments by domestic steel mills in 1991 are forecast at about 77 million tons, down from 85 million tons the year before. While steel demand is down about 7 percent, shipments have been helped by rising exports and lower imports. Users appear to have liquidated inventories to a lesser extent than in prior recessionary periods. A key positive for the steel companies has been a sharp pick-up in orders in the June-August period after four extremely low months. Prices of spot flat-rolled steel for fourth quarter delivery have risen about 3-4 percent recently.

The consensus calls for domestic deliveries to rise to about 80 million tons in 1992. For our part, we think shipments may remain flat at 77 million tons. We do not see a sharp recovery of steel demand because the domestic capital equipment cycle has stagnated (reflecting pressures on industrial companies' profits) and no sizable snap-back seems possible in the private construction sector. Also, reflecting the sharp decline of world steel spot export prices in recent months, steel imports in 1992 may rise from 16 to 18 million tons, with exports down from 6 to 4 million tons. Hence, granted that steel consumption rises from 87 to 90 million tons and that steel users do not change their inventories, this works out to domestic deliveries in 1992 of only about 77 million tons.

An important issue confronting major domestic steelmakers is their ability to sustain profits when the operating rate is only fair (as expected in 1992). The industry has become increasingly global. New technologies are revolutionizing the industry. Currently, there are 29 producers of flat-rolled steel in the United States and Canada. Many foreign mills are also vying for this market. Furthermore, Nucor, the country's leading minimill, has built an 0.8-million-ton-per-year thin-slab/flat-rolling mill in Indiana and has a second 1.0-mtpy facility under construction in Arkansas. 1992 could be another year of profit declines in the steel sector.

Agriculture: Slower Food Price Increases

Robert L. Thompson
Purdue University

Weather, here and abroad, is the dominant factor in the outlook for agricultural markets. Drought, especially severe in the eastern Corn Belt, dropped 1991 U.S. corn production by a projected 8 percent, and soybeans by 5 percent, relative to 1990. Similarly, poor growing conditions in the USSR have cut their grain crop by an estimated one-third to 190 million metric tons in 1991. The reduced U.S. inventories of grain together with the short Soviet crop are the two key factors that will dominate grain markets into 1992. The key to how much prices strengthen will be the magnitude of food aid or export credits made available to the Soviet Union.

In other farm sectors, the 1991 U.S. cotton crop is projected to be the largest since 1937, and sugar output may set a new record.

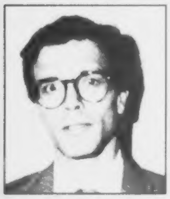
After several years of record livestock receipts, large inventories of beef cattle and hogs moving to markets have significantly reduced meat prices in 1991.

Net income of American farmers in 1991 is likely to fall about 10 percent from the 1990 record, and will likely be the lowest since 1986. The principal causes of this drop are lower livestock and milk prices and the smaller grain production. The drop in farm income is causing an increase in farm financial stress relative to the last several years, especially in the eastern Corn Belt.

The implications for the farm input industries are mixed. Farmers will probably be required to set aside less farm land in 1992, and the resulting increase in area planted will stimulate purchases of seed, fertilizer, farm chemicals, and energy. On the other hand, the weakened financial position of many farmers is likely to depress sales of farm equipment.

With lower meat prices leading the way, the increase in food prices in 1991 should be only 2-4 percent, down from 5.8 percent in both 1989 and 1990. This slower rate of increase in food prices should continue well into 1992, at least until the next crop can be predicted with some accuracy.

Paper: Recovery Ahead



John Chrysikopoulos
Goldman Sachs

Demand for paper products is primarily influenced by economic conditions. During the first half of 1991, demand declined for virtually every product category, but now it appears that this trend is reversing, albeit at a very modest pace. The industry has, therefore, passed the low point of the demand cycle, and a recovery, expected to become apparent before year end, should last for the next two years or so.

Paper Industry Operating Rates *(percent)*

	1980-90 Average	1991E	1992E	1993E
Newsprint	93.2	88.6	88.9	91.9
Uncoated free sheet	92.5	87.9	86.5	90.4
Coated	92.6	86.6	87.9	90.0
Tissue	92.9	96.8	96.3	96.0
Linerboard	94.5	93.4	92.6	94.1
Bleached paperboard	92.9	93.4	93.5	92.8

Industry operating rates, the key to prices and profits, are expected to remain depressed through 1992, given the significant capacity additions currently under way coupled with an environment of below-trend economic (and paper-demand) recovery. As detailed in the first table, a meaningful improvement in operating rates for the key paper product lines is not expected until 1993. More important, the level of operating rates through 1993 is forecast below the average of the last ten years.

Selling prices for key product lines are expected to improve in advance of the operating rates due to a turnaround in market psychology, driven by expectations of continued stronger demand conditions, inventory accumulations, and the absence of any major new machine startups. New capacity tends to depress selling prices prior to startup as companies try to pre-sell the output. The improvement in selling prices is forecast as early as the fourth quarter. Over the next two years, industry sales and earnings are expected to improve dramatically from the very depressed 1991 levels (second table), primarily due to higher selling prices and volumes and lower costs resulting from more efficient machines and higher operating rates.

Paper Industry Sales and Earnings

(percent changes, year over year)

	Sales	Earnings
1990	20.4	-34.2
1991E	-2.8	-43.9
1992E	9.5	80.3
1993E	5.6	40.0

Chemical Industry: Lackluster Recovery

Robert S. Reitzes
C. J. Lawrence

The recovery in the chemical industry has been lackluster this year. Sales are only 3.3 percent above a year ago and profits have declined for most companies. Over the next 6-9 months the outlook is for continued modest growth but with pricing depressed.

Wholesale chemical prices remain weak, dropping 3.8 percent in July and in six of the past seven months. Prices have declined as a result of new capacity, a rundown of inventories, a decline in raw material prices and weakness in the economy. With only a modest economic pick-up expected, it is doubtful that prices will rise significantly. Prices appear to be close to their cyclical lows, however. For example, polyethylene, chlorine, and styrene prices are close to historic lows. On the positive side, inventories declined in July for the fourth straight month and appear to be at extremely low levels.

To improve profits, several large chemical companies have undertaken significant restructuring programs — Du Pont, Monsanto Company, and Imperial Chemical Industries. These companies are not waiting for the recovery but have decided to lay off large numbers of employees and sell off or shut down poor operations. In addition, most companies have completed large-scale capital spending programs to increase capacity, improve productivity, and reduce environmental concerns.

Going forward, chemical companies that purchase raw materials such as propylene and ethylene will benefit from the decline in materials prices. In addition, lower interest rates should contribute to a gradual improvement in housing and autos — two of the most important customers of the chemical industry. The fiber industry has already turned around, while the paint industry is also improving. Plastics and industrial chemicals are lackluster.

Chemical earnings are expected to pick up next year as the economy recovers and restructuring efforts take hold. For the non-commodity companies, earnings could be up by 15 percent — accelerating in the second half of next year. For the commodity producers, because pricing deteriorated throughout most of the second and third quarters of this year, earnings will be flat to down.

Business Services: Still Growing

Michael P. Niemira
Mitsubishi Bank

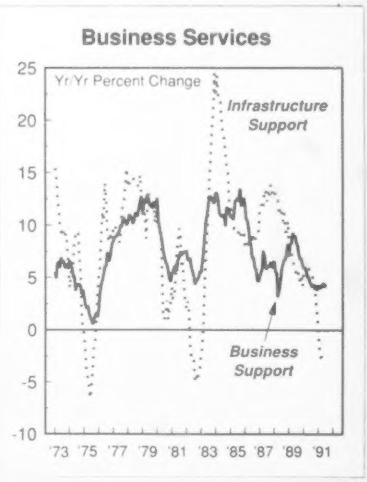
Business services, still one of the fastest growing sectors of the economy, are a highly diverse industry. It is useful to think of business services as being composed of two distinct segments: *business support services*, including advertising, credit reporting, and data processing, and *infrastructure support services*, which include temporary help companies, mailing and reproduction services, and building maintenance. Between 1973 and mid-1991, employment in business support services grew by an average of 7.5 percent per year. Business infrastructure services employment also expanded by a remarkably strong 8.0 percent pace. This growth, which was stimulated by more and more companies jettisoning some of their support operations, preferring instead to purchase those services, took place at a rate about four times faster than the growth of the total U.S. workforce.

Business Services *(Percent change)*

	Output	Profits
1988	12.2	6.6
1989	10.3	7.4
1990E	7.7	6.9
1991E	5.0	5.4
1992E	9.2	8.2
1993E	9.1	9.4

Over the next year, temporary help companies, about one third of the industry, should experience a healthy rebound in business. Two factors will help propel their growth: First, demand from companies that experience a "work overload" situation as the economy picks up momentum and, second, the greater use of temporary help by the Federal government, which now is a small part of the demand for that business.

International competition for business services is heating up. Advertising, public relations, and management-information-systems firms are mounting a major international push to secure 1992 European Community contracts. The risks and rewards are great and the competition with Japanese and European companies is intense. Ultimately, the trend toward more professional specialized services is likely to continue and result in significant growth of the business services industry.



The Potency of Ideas

by Joshua Muravchik

America has won the cold war — almost without trying — and there is an important lesson in this: the potency of ideas in international politics. Ironically, we Americans, who possess a profound and successful idea, have rarely understood the potency of ideas, while the Communists, who possess a false and failed idea, have understood it quite thoroughly. Thus, during most of the cold war, even dealing from a weaker hand, they outdid us in the realm of political competition, merely by working at it so much harder. What little Americans know about ideological combat we learned in reacting to the Communists. Yet despite our ineptness, the democratic idea proved enormously powerful.

As Communist regimes tumbled in Eastern Europe, Americans were surprised to see the depth of yearning for democracy and the degree to which people understood at least the essential outlines of the democratic idea. When East Germans took to the streets of Leipzig, Czechs to the streets of Prague, or even Romanians to the streets of Bucharest, they were strikingly clear in their demands. They asked not for a true press but a free press, not for enlightened rulers but for free elections, not for a reformed party but a multiparty system. They homed in on the essence of democracy despite the confusion that their rulers attempted to sow about the meaning of "democracy," an effort that seems to have borne more fruit among Western academics and publicists than among East European subjects.

And now that we have seen how firmly East Europeans grasped the concept of democracy, we often hear that the Chinese students who gathered in Tiananmen Square to demand democracy did not really understand the meaning of the term. Perhaps not. But it is striking that they chose to model their goddess of democracy in the shape of the Statue of Liberty.

The death throes of communism mark the beginning of the twenty-first century. It may be the American century. Henry Luce once said that the twentieth century would be the American century. But in fact it is better recognized as the totalitarian century. The various totalitarian systems now all seem to be ending in failure, but while they lived, they called the action. America emerged victorious over them all, but each of those victories came in defense.

If, however, we can advance the spread of democracy, perhaps not everywhere but at least to the majority of mankind, then the twenty-first will be the true American century. This will come about not by the spread of American power or by the exact imitation of American institutions but by the spread of those profound and humane ideals on which America was founded.

Excerpted from a summary of *Exporting Democracy: Fulfilling America's Destiny*, by Joshua Muravchik, The AEI Press, Washington, D.C., 1991. Dr. Muravchik is resident scholar at the American Enterprise Institute.

Problems of Economic Conversion

(An illustrative story from Russia, surely apocryphal)

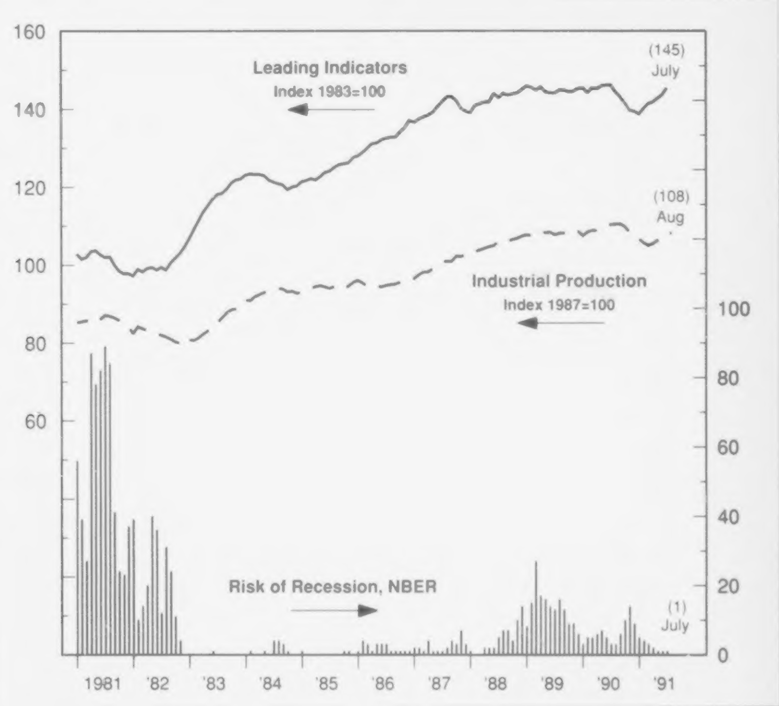
A Soviet factory that had produced missiles under the old regime converted to the production of wheelbarrows. Because the factory was capable of doing first-quality work and was accustomed to dealing with high-tech metals, it decided to make the barrows out of vanadium. Technologically, the implement proved to be a great success; it will probably last a thousand years. But excessive material costs made the wheelbarrow a complete failure economically.

Conference Board Stat File

Classic Business Cycle

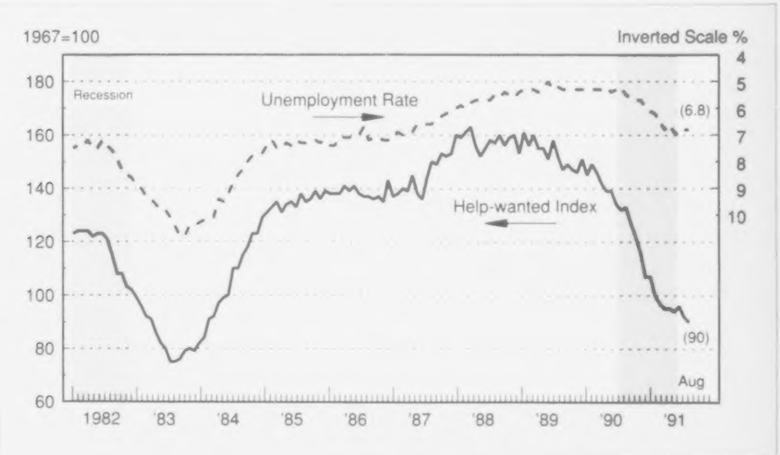
The U.S. business cycle continues to track a classical recession-recovery pattern. The contraction ended in April or May and the recovery — contrary to the anxiety heard so often these days — promises to continue into and through 1992. Where will the increases in demand come from? Inventory rebuilding and exports, notably, with consumer spending, capital investment and single-family housing contributing as well. Large-scale construction will be a drag. The pace of recovery is problematical, but the guess here is near the high end of the range found on our "Crystal Ball" page. Inflation is easing toward 4 percent. All in all, not an unhappy outlook. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Classical cyclical recovery continues.

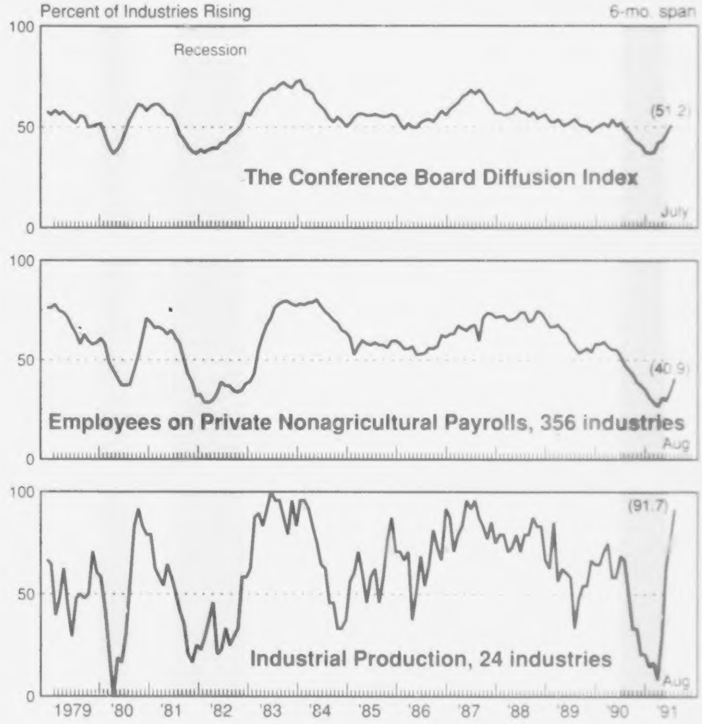
Help-wanted Advertising and Unemployment



No pick-up yet.

Conference Board Stat File

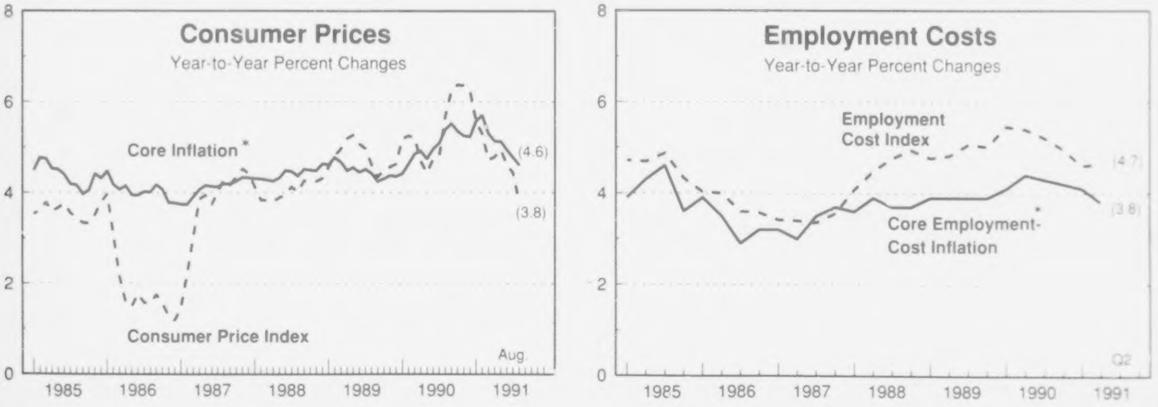
Indexes of Economic Momentum



Momentum strengthens further.

Slowing of inflation now fully evident.

Inflation Fundamentals

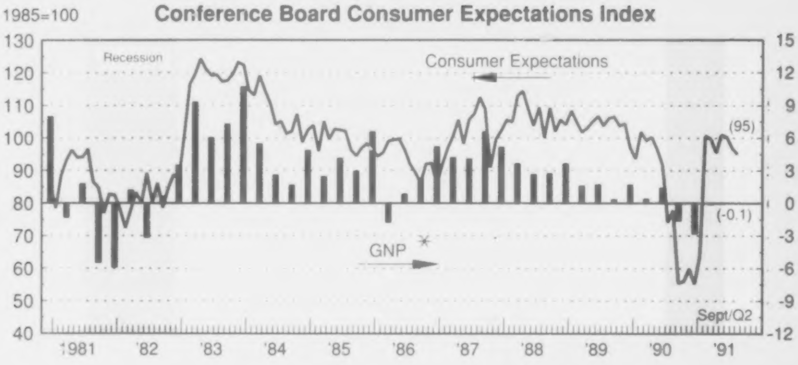


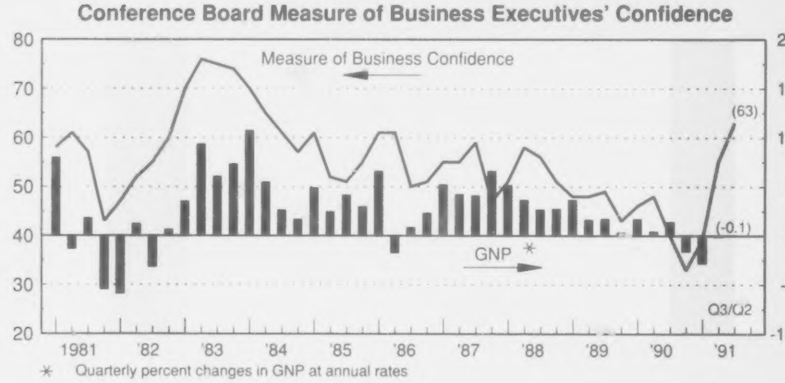
* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI.)

Conference Board Stat File

Confidence

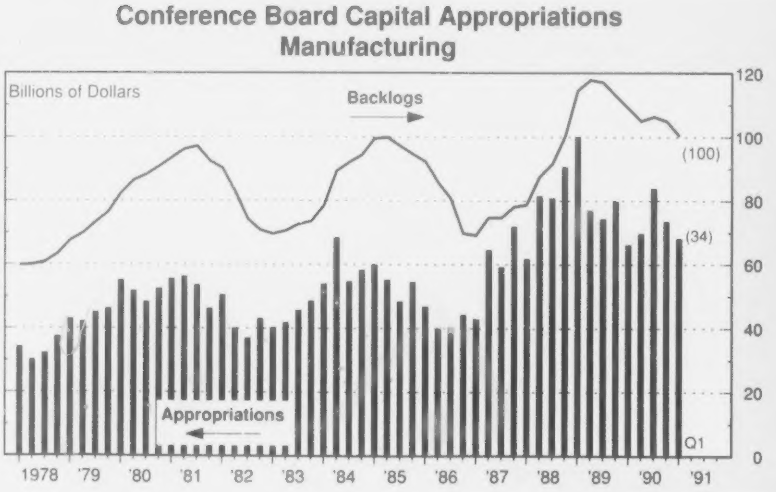

Conference Board Consumer Expectations Index


Conference Board Measure of Business Executives' Confidence

* Quarterly percent changes in GNP at annual rates

Both measures at recovery levels but not ebullient.

Investment Intentions


Conference Board Capital Appropriations Manufacturing

Export strength limits recession weakness.

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE
Date of Forecast		Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.

Gross National Product

(Quarter-quarter percent change, constant dollars, seasonally adjusted at annual rates)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE		
		%	%	%	%	%	%	%	%	%	%	%		
Actual	1991 1Q	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8	1Q 1991	Actual
	2Q	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.4	2Q	
Forecast	3Q	2.0	3.7	2.7	2.2	3.6	2.7	3.7	3.1	3.4	2.6	2.9	3Q	Forecast
	4Q	3.6	3.4	2.7	2.9	3.4	2.6	3.9	2.2	2.6	4.4	3.6	4Q	
	1992 1Q	4.6	2.9	3.0	2.4	3.3	2.5	4.1	2.8	3.8	3.8	3.0	1Q 1992	
	2Q	4.2	2.6	3.3	2.3	3.4	1.9	3.3	3.1	3.3	4.2	2.6	2Q	
	3Q	3.3	2.3	3.4	2.7	3.2	2.3	2.4	3.5	2.2	3.5	2.4	3Q	
	4Q	1.9	2.0	3.3	2.5	3.0	2.3	3.0	2.5	2.2	2.6	1.9	4Q	
	1993 1Q	1.8		2.9			1.9	3.9	3.2	3.3	2.3	1.8	1Q 1993	
	2Q	1.6		2.9			1.9	2.7	2.6	3.1	2.6	2.0	2Q	
	3Q	3.0		2.7			2.0	1.8	3.1	3.1	3.0	2.1	3Q	

Inflation (GNP Deflator)

(Percent change from same quarter one year earlier)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE		
Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.4	4.1	4.1	4.3	4.4	3.6	3.7	4.0	3.6	3.0	3.8	1991 4Q	Forecast
	1992 4Q	3.0	3.9	3.6	3.7	4.0	4.1	2.3	2.7	2.7	3.0	3.5	1992 4Q	

30-Yr Treasury Bond Rate

(Percent per annum, quarterly)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE		
Actual	1991 1Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	1Q 1991	Actual
	2Q	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	2Q	
Forecast	3Q	8.4	8.3	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.4	3Q	Forecast
	4Q	8.5	8.3	7.8	8.0	7.9	8.0	8.2	7.8	8.1	8.1	8.3	4Q	
	1992 1Q	8.6	8.1	7.9	8.1	7.9	7.9	8.4	7.7	8.3	8.2	8.4	1Q 1992	
	2Q	8.7	8.4	8.0	8.3	8.0	7.9	8.4	7.6	8.4	8.3	8.4	2Q	
	3Q	8.7	8.3	8.0	8.4	8.1	8.1	8.4	7.6	8.1	8.3	8.3	3Q	
	4Q	8.8	8.3	8.0	8.6	8.2	8.2	8.5	7.5	7.9	8.4	8.2	4Q	
	1993 1Q	8.9		8.0		8.3	8.3	8.5	7.4	8.0	8.5	8.1	1Q 1993	
	2Q	8.9		8.0		8.4	8.4	8.4	7.3	8.0	8.6	8.1	2Q	
	3Q	8.9		8.1			8.5	8.4	7.2	8.1	8.7	8.2	3Q	

Unemployment Rate

(Percent, quarterly)

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE		
Actual	1991 1Q	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	1Q 1991	Actual
Forecast	1991 4Q	6.7	6.9	6.7	7.0	6.8	6.8	6.8	6.8	6.8	6.9	6.8	4Q 1991	Forecast
	1992 4Q	5.9	6.5	6.3	6.7	6.4	6.6	6.5	6.4	6.3	6.5	6.5	4Q 1992	
	1993 2Q	5.9		6.1			6.6	6.0	6.1	6.1	6.3	6.5	2Q 1993	

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